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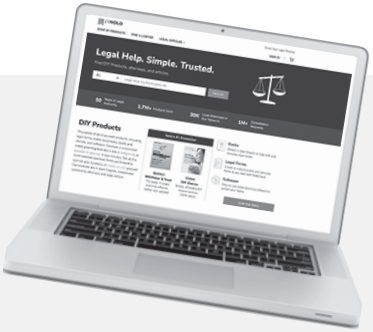


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"Peri walks you through many of the most intimidating aspects of running a small business with solid, tested strategies for success."

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"The Small Business Start-Up Kit *not only helped me launch my multifaceted business both practically and successfully, it helped me appropriately prepare for that launch (and guided me through those first several months of confusion, uncertainty, and excitement). Peri generously offers her experience and expertise to readers as she clearly addresses everything from choosing the right business name to paying taxes to hiring employees. I could not have opened my art gallery or formalized my freelance services without this book, nor would I dare embark on any other business ventures without it!"*

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13th Edition

The Small Business Start-Up Kit

Peri H. Pakroo, J.D.

NOLO
LAW for ALL

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Dedication

I dedicate this book to my grandmother Eunice Michaelson Jones—
a spitfire if ever there was one.

About the Author

Peri Pakroo (peripakroo.com) is a consultant and entrepreneurship educator with a focus on business strategy, digital communications, and community-building. For more than 20 years she has worked to empower people to build economic independence and strong communities. She is the founder of P-Brain Media (pbrainmedia.com), a business consulting and digital services firm.

Peri received her law degree from the University of New Mexico School of Law in 1995, and a year later began editing and writing for Nolo, specializing in small business and intellectual property issues. She is the author of the top-selling Nolo titles *The Women's Small Business Start-Up Kit*, *The Small Business Start-Up Kit* (national and California editions), and *Starting & Building a Nonprofit*, and has been featured in numerous national and local publications including *Entrepreneur*, *Real Simple*, *Investor's Business Daily*, and *BusinessWeek*. For several years Peri taught adult education courses at WESST in Albuquerque, a nonprofit whose mission is to facilitate entrepreneurship among women and economically disadvantaged communities in the state of New Mexico. She is active in supporting local, independent businesses and is a cofounder of Sustainable Equitable Economic Democracy New Mexico (SEED NM).

Peri lives with her family in New Mexico and is always looking forward to the next road trip. She is a musician in a number of bands, including her own project, Peri & the FAQs.

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Your Small Business Start-Up Companion

You don't have an MBA. Hell, you've never taken a business class. You spent your college years studying literature and art history, and periodically dropping out to travel the world. And now you find yourself thinking about going into business for yourself—maybe as a photographer, an owner of a café, or the founder of a software company. "Me, a businessperson?" you skeptically wonder. You keep trudging to work each morning, but as the hours tick by, you find yourself fantasizing more and more about kissing your 9-to-5 job goodbye. You jot down some notes, work out some kinks in your plan and continue to wonder whether it just might fly….

Unfortunately, most people who have toyed with business ideas this way never get to find out whether they would have worked. For a variety of practical, financial, and psychological reasons, most folks just don't take the leap from idea to reality. Certainly in some cases this might be a good thing. Having consulted with prospective start-ups for many years, I know full well that not all business ideas are good ones. But I find it such a shame when a would-be entrepreneur with terrific ideas gets thwarted or hung up on issues that really don't have to be terminal.

Folks new to the world of small business commonly report they get stuck because they don't know how to do things like write a business plan, do market research, price their goods or services, make financial projections or reports, manage staff, or draft a contract. The truth is, none of these tasks involve rocket science. Each can be done—and done effectively—with a simple, systematic approach. That's what this book offers: an easy-to-understand, step-by-step approach to all the important tasks an entrepreneur needs to tackle.

Although Conditions Change, the Elements of Success Are the Same

While so many aspects of business are subject to relentless change—technology and global economic conditions are two particularly volatile factors—the good news for those just starting a business is that the elements of success remain pretty constant. Businesses tend to succeed when they (1) offer products or services that

customers want; (2) do so with efficient operations, savvy marketing, and consistent sales efforts; and (3) have solid financial management. Period.

Some of you may be saying "Sure, that *sounds* easy, but I have no idea how to actually *do* any of those things!" Know that you're not alone, and learning how to break down the essentials of what makes a business successful is actually not terribly complicated. For example:

- Don't know whether enough customers actually want your product or service? Start small and grow slowly, based on what you learn along the way. Prioritize doing simple, inexpensive market research to learn more about your customers and get their feedback about your offerings.
- Don't know how to manage a retail store or a small services firm? Break down your activities into systems, write out procedures and checklists, and consider using technology (like project management software) to help streamline operations.
- Don't know how to create a website or use social media? Consider adding someone with these skills to your team, either as an employee or as an independent contractor.
- Hate doing sales? Consider bringing on a sales-oriented partner, manager, or independent contractor.
- Don't know how to track your money or prepare financial reports? Read up on the basics (as in this book), occasionally hire a bookkeeper for some hands-on learning sessions, and use software that makes generating reports easy.

The chapters in this book focus on these and other important business tasks and systems, breaking them down into simple steps that are easy to get started. Even if you feel like a fish out of water in the "business world," you'll have a clearer idea of the key inner workings of a successful small business—and how to set one up yourself—once you read through this book.

Systems Facilitate Success

Instead of feeling overwhelmed at the novel tasks ahead, take heart in knowing that using some tried-and-true methods can radically boost your chances of success. Perhaps the most powerful of these is to establish systems for important tasks like managing finances, marketing your products or services, hiring staff, and so on. From simple systems like checklists and procedures put in writing, to complex software used to manage projects or clients, thoughtful systems can make a huge difference in how a business runs.

When efficient systems are in place—for example, you have clear, step-by-step procedures for entering receipts into your bookkeeping software, planning the year's marketing initiatives, or performing annual reviews for employees—valuable mental time is freed up. When you and your managers aren't constantly reinventing the wheel with your operations, you can think about really important things, like what industry changes are on the horizon, what trends are happening with customer tastes, or how to distinguish your company from its competition.

I encourage you to try to envision your business like a machine with various moving parts. Successful businesses manage to keep those parts moving with a minimum of direction from owners or supervisors—and well-established systems are the best way to achieve this.

Why This Book Is a Must for Start-Ups

Unlike many other small business guides, this one won't spend your precious time quizzing you on whether you really want to start a business after all. If you need more help deciding whether entrepreneurship is for you, you should probably buy a different book. If, on the other hand, you want a book that cuts to the chase and explains what you need to do to plan and launch a business officially and legally, this book is for you. It's organized so you can skip around to whatever topics you're grappling with at the time; you don't need to read the book from cover to cover. If you are already knowledgeable about a topic or you've already taken care of a particular task, you can either skip those chapters or use them as a guide to evaluate what you've already done.

Take the Leap

One of the main ideas to take away from this book is that there's nothing mysterious or even terribly complex about the process of starting your own business. Whether you've drafted a highly detailed business plan with the help of accountants and consultants or you've tapped it out on a phone screen, the process of fleshing out that idea, refining it, and turning it into a legitimate business is the same.

This book will help you build an efficient operation that, over time, will free you from day-to-day business tasks so you can focus your energies on big-picture strategic development, which is at the heart of the role of business owner.

It's way too easy to get mired in operational details, so it's essential to create boundaries and find breathing room on a regular basis so that you can step back, evaluate market conditions,

Entrepreneur's Insight

Stephen Parr, Founder and Director of Oddball Film and Video, a stock film and video footage company in San Francisco, California (www.oddballfilms.com)

I started making video art in the 1970s. After a while I started collecting all these weird bits of film because it was cheaper than shooting it myself. I gathered all kinds of old, found footage, like military training films, educational films, home movies, and all kinds of other images, and put them together into montages, which I screened in nightclubs as background visuals. I was showing them all over—nightclubs in New York, Chicago, San Francisco—and I made some money by selling the tapes to the clubs.

Then I started getting calls from companies in Silicon Valley that produce industrial videos, like training films and promotional programs for corporate trade shows. Video game companies were calling, too. Companies like Sega, Sun Microsystems, and Silicon Graphics wanted to pay me for my footage. Friends thought I should go into business selling the stock footage I had collected, but I didn't know if I could make a living doing it. I didn't know anything about the stock footage business. There were a few companies doing it, but they were in New York or LA, and they seemed really huge.

But since I liked working with images and since the business had already started to take off on its own, I decided to formalize it. I wanted an interesting company name that conveyed what I did. We came up with Oddball. It's a word that people don't really use anymore, more of a '40s or '50s expression—an oddball is someone kind of weird, unbalanced, or unusual, you know?

At the most basic level, my business involves finding, organizing, and preserving historical footage. And then distributing it. Our clients include ad agencies; news organizations; documentary and feature filmmakers; industrial, corporate, and music video producers; educational filmmakers; and anyone who needs offbeat and unusual images. In one way, we're like a library: We archive and license historical visual information.

These days, I spend most of my time trying to organize and publicize my business. And I spend a lot more time trying to obtain films than actually looking at them. Still, what I do at Oddball is an extension of the work I've been doing since the 1970s. I guess it became a business the day I decided I wasn't going to do anything else.

spot opportunities and threats, and take action to keep your business on a profitable course. You'll need confidence to make important business decisions—and you'll need guts, too. You may well find that some of the questions burning in your mind have no clear answer, because no one has asked those particular questions or tried those ideas before. You probably wanted to start a business in the first place so that you could call your own shots—but this can often be quite a heavy burden. You may not believe it now, but some days you'll probably find yourself wishing you had a boss.

You'll need to learn to trust yourself, both when you feel optimistic and when you suspect that one of your ideas is less than brilliant. You'll also have to develop a sense for when you need help and learn to be judicious in taking the advice of people around you. Part of the art of controlling your own destiny is accepting the wisdom of others while maintaining your own focus and direction. It's not always an easy balance to maintain, but you'll undoubtedly get better at it as you gain experience in running your own show. The bottom line: Think hard, keep your mind open—and fight like hell to make your ideas a reality.

Take the leap.

Finding Government Agencies and Forms Online

Throughout your journey of conceptualizing, planning, forming, and running your small business, you'll need to access information and forms from federal, state, and local government agencies and offices. Here are some suggestions on how to write a successful search query:

- For federal tax information and forms, go to www.irs.gov and type the name of the publication or form (or its number) in the search box.
- For general information about small businesses in your state, try "[your state] small business information."
- For state tax information, try "[your state] tax agency" or [your state] department of revenue."
- To find state sales tax or permit agencies, try "[your state] state sales tax and permits."
- For information on LLC formation and rules, type "[your state] LLC filing."

Your search results will probably include ads paid for by companies that will, for example, file your LLC for you, at a price. Unless you want to use such a service, skip the results prefaced by "Ad," and keep looking for a government site, normally ending with .gov.

More Small Business Products From Nolo

Nolo's website (www.nolo.com) offers books, software, online legal forms, a lawyer directory, and free legal information to help businesses solve specific legal problems. Here are some of the most popular business titles. You'll find more online, including an online LLC formation service.

Commercial Leases

Legal Forms for Starting and Running a Small Business
by Fred S. Steingold
Contains several customizable leases for businesses renting space in a multi-tenant building or a stand-alone space, as well as many other useful forms.

Forms of Ownership

Nolo's Online LLC
Use Nolo's online app to form your LLC in any state.

Nolo's Online Corporation
Use Nolo's online app to form your corporation in any state.

LLC or Corporation? Choose the Right Form for Your Business
by Anthony Mancuso
Explains the legal and tax differences between LLCs and corporations.

Nolo's Guide to Single-Member LLCs
by David M. Steingold
Provides an overview of how to form and run a single-member LLC, including unique tax and liability issues.

Business Buyout Agreements: Plan Now for All Types of Business Transitions
by Bethany Laurence and Anthony Mancuso
Explains how to protect your business interests by drawing up a "premarital" agreement between you and your business owners that sets out a plan for what happens if you or a co-owner leaves the company. A must for any new business with more than one owner.

Intellectual Property

Trademark: Legal Care for Your Business & Product Name
by Stephen Fishman
The information and forms you need to choose a distinctive trademark, register it, and fight infringers.

Tax

Deduct It! Lower Your Small Business Taxes
by Stephen Fishman
Take all the business tax deductions you're due! Write off travel expenses, meals, and much more.

Home Business Tax Deductions: Keep What You Earn
by Stephen Fishman
The complete guide to the tax deductions your home business can claim—including your home office costs.

Tax Savvy for Small Business
by Frederick W. Daily and Stephen Fishman
Offers plain-English explanations of tax laws and rules on business deductions, plus tax info on LLCs, partnerships, corporations, and more.

More Small Business Products From Nolo (continued)

Workplace Laws

The Employer's Legal Handbook
by Fred S. Steingold
All the basics of employment law in one place—including safe hiring and firing practices, wages, hours, employee benefits, taxes and liability, discrimination, and sexual harassment.

Consultant & Independent Contractor Agreements
by Stephen Fishman
Explains all the tricky IRS rules and provides downloadable forms and instructions for working with independent contractors.

Get Forms and More at This Book's Companion Page on Nolo.com

You can download any of the forms and worksheets in this book at:

www.nolo.com/back-of-book/SMBU.html

See the Appendix, "How to Use the Downloadable Forms on the Nolo Website," for a complete list of forms available on Nolo.com.

CHAPTER 1

Choosing a Legal Structure

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Choosing the Best Structure for Your Business 35

You probably already have a rough idea of the type of legal structure your business will take, whether you know it or not. That's because, in large part, the ownership structure that's right for your business—a sole proprietorship, partnership, LLC, or corporation—depends on how many people will own the business and what type of services or products it will provide, things you've undoubtedly thought about quite a bit.

For instance, if you know that you will be the only owner, then a partnership is obviously not your thing. (A partnership by definition has more than one owner.) And if your business will engage in risky activities (for example, providing financial planning advice or repairing roofs), you'll want not only to buy insurance, but also to consider forming an entity (like a corporation or a limited liability company) that provides personal liability protection, which can shield your personal assets from business debts and claims. If you plan to seek venture capital or want to give your employees stock options, you should form a corporation.

If you've already considered these issues, you'll be ahead of the game in choosing a legal structure that's right for your business. Still, you'll need to consider the benefits and drawbacks of each type of business structure before making your final decision.

Limited Liability

Some business entities provide their owners with "limited liability" and others don't. Corporations and LLCs each provide owners with limited personal liability. Sole proprietorships and general partnerships do not.

Limited liability basically means that the creditors of the business normally cannot go after the owners' personal assets to pay for business debts and claims arising from lawsuits. (Liability for business debts is discussed in detail later in this chapter.)

As you read about specific business types in this chapter, you'll see how a decision to form a limited liability entity (a corporation or an LLC, mainly) can dramatically affect how you run your business. On the other hand, sole proprietorships and partnerships (which are somewhat simpler to run than corporations and LLCs) can leave an owner personally vulnerable to business lawsuits and debts.

In all states, the basic types of business structures are:

- sole proprietorships
- partnerships (general and limited)
- limited liability companies (LLCs), and
- corporations.

To help you pick the best structure for your business, this chapter explains the basic attributes of each type.

This chapter will also help you answer the most common question new entrepreneurs

ask about choosing a business form: Should I choose a business structure that offers protection from personal liability—a corporation or an LLC? Here's a spoiler: Most states make the process of forming an LLC quite easy and inexpensive, and LLCs meet the needs of most businesses and will protect your personal assets from claims against the business. Some businesses—like those that intend to seek equity capital—might require the more complex corporate entity, but most won't.

Making the Decision to Go Official

You might be grappling with a more preliminary question than which legal structure you should choose—whether to formalize your business—to go the official route and register it with the appropriate state and federal agencies. For instance, maybe you've been doing freelance graphics work on the side for a number of years, but now you're thinking of quitting your 9-to-5 job to take on graphics work full time.

Generally speaking, anyone with a good-sized or otherwise visible business should bite the bullet and complete all of the necessary registration tasks to become official. Operating under the table can all too easily be exposed, and the government can come after you for fines and penalties, simply for operating without the necessary paperwork. And if you're making a profit, ignoring the IRS is definitely a bad idea. Besides fines and back taxes, you could even face criminal charges and jail time.

On the other hand, tiny, home-based, hobby-type businesses can often operate for quite some time without meeting state and local registration requirements. (You always need to report the income from such businesses to the IRS and to your state if it has an income tax.) If you're braiding hair or screen printing T-shirts or holding an occasional junk sale out of your garage, for instance, you can probably get by without formal business registration—at least for a while. Keep in mind, however, that just because it might be possible doesn't mean it's the better option. Often, formally registering your business can benefit you, the owner, as well, since you can then write off business expenses and reduce your personal taxes. In Chapter 9, we discuss hobby businesses in more depth, including how tax laws deal with businesses that continually lose money.

If you're not sure whether you want to register your business and open it up to the world of government regulations, the information about registration requirements in this book will put you in a better position to make a decision. Chapter 7 walks you through the many governmental requirements that apply to all new businesses, and explains how to go about finding and satisfying any additional requirements that may apply to your specific business.

Sole Proprietorships



SKIP AHEAD

Sole proprietorships are one-owner businesses. Any business with two or more owners cannot, by definition, be a sole proprietorship. If you know that your business will have two or more owners , you can skip ahead to "Partnerships," below.

A sole proprietorship is simply a business that is owned by one person and that hasn't filed papers to become a corporation or an LLC. Sole proprietorships are easy to set up and to maintain—so easy that many people own sole proprietorships and don't even know it. For instance, if you are a freelance photographer or writer, a craftsperson who takes jobs on a contract basis, a salesperson who receives only commissions, or an independent contractor who isn't on an employer's regular payroll, you are automatically a sole proprietor. This is true whether or not you've registered your business with your city or obtained any licenses or permits. And it makes no difference whether you also have a regular day job. As long as you do for-profit work on your own (or sometimes with your spouse—see "Running a Business With Your Spouse," below) and have not filed papers to become a corporation or a limited liability company, you are a sole proprietor.



CAUTION

Don't ignore local registration requirements. If you've started a business without quite realizing it—for example, you do a little freelance website development, which classifies you as a sole proprietor by default—be aware that you have likely not satisfied the local governmental requirements for starting a business. Most cities and many counties require businesses—even tiny home-based sole proprietorships—to register with them and pay at least a minimum tax. And if you do business under a name different from your own (say, Christina Kennedy does business under the name "Monster Photography"), you usually must register that name—known as a fictitious business name or more commonly a DBA (doing business as)—with your county. In practice, lots of businesses are small enough to get away with ignoring these requirements. But if you aren't in compliance and you are caught, you might be subject to back taxes and other penalties. (See Chapter 7 for an explanation of how to make the necessary filings with the appropriate government offices.)

Pass-Through Taxation

In the eyes of the law, a sole proprietorship is not legally separate from the person who owns it. This lack of legal separation is one of the fundamental differences between a sole proprietorship and a corporation or an LLC, and it has two major effects: one related to taxation (explained in this section), and the other to personal liability (explained in the next section).

Running a Business With Your Spouse

If you plan to start a sole proprietorship and expect that your spouse might occasionally help out with business tasks, you should be aware of a fuzzy area in federal tax law that you can use to your advantage. The IRS typically allows a spouse to pitch in without risking being classified as an owner or as an employee of the other spouse's business. This situation is sometimes erroneously called a "husband-wife sole proprietorship."

The normal rule is that someone who does work for a business must be (from a legal standpoint) a co-owner, an employee, or an independent contractor. But your spouse can volunteer—that is, work without pay—for your sole proprietorship without being classified as an employee, freeing the business from paying payroll tax.

This arrangement saves you money—and, if you have no other employees, also allows you to avoid the time-consuming record keeping involved in being an employer. Similarly, a spouse who is not classified as a partner or an independent contractor won't have to pay self-employment taxes, and your business won't have to file a partnership tax return.

Also consider that under marital property laws that vary from state to state. If a business is started or significantly changed when a couple is married, both spouses may have an ownership interest in the business regardless of whose name is on the ownership document.

If you are concerned about the possible consequences of divorce, read Chapter 15, "Planning for Changes in Ownership." It discusses how divorce and other life events, such as retirement and death, can affect ownership of a business and explains how to plan in advance to accommodate the possibilities. You might also want to check with a lawyer who is experienced in handling marital property issues to see how your business could be affected in the event of a divorce in your state.

Finally, if you and your spouse both want to be active partners in a co-owned business—each with an official say in management—you should create a partnership, LLC, or corporation, even though doing so will mean filing somewhat more complicated tax returns and other business paperwork. If your spouse tries to squeak by as a volunteer in a so-called husband-wife sole proprietorship when you're really working together as a partnership, and you're audited, you run the risk of having the IRS declare the business a partnership and socking your spouse with back self-employment taxes.

At income tax time, a sole proprietor simply reports all business income or losses on their individual income tax return. The business itself is not taxed. The IRS calls this "pass-through" taxation, because business profits pass through the business to be taxed on the business owner's tax return. You report income from a business just like wages from a job, except that, along with Form 1040, you'll need to include Schedule C, on which you'll provide your business's profit and loss information. One helpful aspect of this arrangement is that if your business loses money—and, of course, many start-ups do in the first year or two—you can use the business losses to offset any taxable income you have earned from other sources.

EXAMPLE: Rob has a day job at a coffee shop, where he earns a modest salary. His hobby is collecting obscure records at thrift stores and rummage sales. Contemplating the sad fact that he has no extra money to spend at the flea market on Saturday morning, he decides to start selling some of the vinyl gems he's found. Still working his day job, he makes business cards with the name "Rob's Revolving Records" and decides to give his microbusiness a go.

During his first full year buying and selling records, he sees that a key to consistent sales is developing connections and trust among record collectors. Unfortunately, while he is concentrating on getting to know potential buyers and others in the business, sales are slow. At year end he closes out his books and sees that he spent nearly $9,000 on records, his website, marketing items such as business cards, and other incidental supplies, while he made only $3,000 in sales. But there is some good news: Rob's loss of $6,000 can be counted against his income from his day job, reducing his taxes and translating into a nice refund check, which he'll put right back into his record business.



CAUTION

Your business can't lose money forever. See the discussion of tax rules for money-losing businesses in Chapter 9.



RESOURCE

Be ready for the day you'll owe taxes. Once your business is underway and turning a profit, you'll have to start paying taxes. (See Chapter 9 for an overview of the taxes that small businesses face.) Taxes can get fairly complicated, however, and you may need more in-depth guidance. For detailed information on taxes for the various types of small businesses, read *Tax Savvy for Small Business* by Frederick W. Daily and Stephen Fishman (Nolo). This book gives exhaustive information on deductions, record keeping, and audits that will help you reduce your tax bill and stay out of trouble with the IRS.

Personal Liability for Business Debts

As a sole proprietor, you have no limited liability—you can be held personally liable for business-related obligations. If your business doesn't pay a supplier, defaults on a debt, loses a lawsuit, or

otherwise finds itself in financial hot water, you, personally, can be forced to pay up (a sobering possibility if you own a house, a car, or other treasures). Personal liability for business obligations stems from the fundamental legal attribute of being a sole proprietor: You and your business are legally one and the same.

As explained in more detail in the sections that discuss corporations and LLCs, below, the law provides owners of these businesses with "limited personal liability" for business obligations. This means that, unlike sole proprietors and general partners, owners of corporations and LLCs can normally keep their houses, investments, and other personal property even if their businesses fail. In short, if you are engaged in a risky business, you might want to consider forming a corporation or an LLC (although a thorough insurance policy can protect you from most lawsuits and claims against the business if your company is a sole proprietorship or partnership).



CAUTION

Commercial insurance doesn't cover business debts. Commercial insurance can protect a business and its owners from some types of liability (for instance, slip-and-fall lawsuits), but insurance never covers business debts. The only way to limit your personal liability for business debts is to use a limited liability business structure, such as an LLC or a corporation (or a limited partnership or limited liability partnership). But it's important to keep in mind that even if you have an LLC or corporation in place, your personal assets might be on the line if you are asked to sign personal guarantees for loans, leases, or other obligations. New businesses that don't have a solid credit history are often asked for such guarantees when applying for loans, lines of credit, or vendor accounts. Considering these risks is part of the important task of risk management, which we discuss in Chapter 8.

Creating a Sole Proprietorship

Setting up a sole proprietorship is incredibly easy. Unlike starting an LLC or a corporation, you generally don't have to file any special forms or pay any special fees to start working as a sole proprietor. You'll simply declare your business to be a sole proprietorship when completing the general registration requirements that apply to all new businesses, such as getting a business license from your county or city or a seller's permit from your state.

For example, when filing for a business tax registration certificate with your city, you'll often be asked to declare what kind of business you're starting. Some cities require only that you check a "sole proprietorship" box on a form, while other cities have separate tax registration forms for sole proprietorships. Similarly, other forms you'll file, such as those to register a fictitious business name and to obtain a seller's permit, will also ask for this information. (These and other start-up requirements are discussed in detail in Chapter 7.)

Partnerships

Bring two or more entrepreneurs together into a business venture, stir gently, and—poof!—you've got a partnership. By definition, a partnership is a business that has more than one owner and that has not filed papers with the state to become a corporation or an LLC (or a limited partnership or limited liability partnership).



CAUTION

Partnerships and registration requirements. Though businesses with two or more owners are partnerships by default, they still must satisfy various governmental requirements for starting a business. Most cities and many counties require all businesses to register with them and pay at least a minimum tax. And if you do business under a name other than the partners' names, you usually must register that name—known as a fictitious business name—with your county. (See Chapter 7 for an explanation of how to make the necessary filings with the appropriate government offices.)

General Versus Limited Partnerships

Usually, when you hear the term "partnership," it means a general partnership. As discussed in more detail below, general partners are personally liable for all business debts, including court judgments. In addition, each individual partner can be sued for the full amount of any business debt (though that partner can turn around and sue the other partners for their share of the debt).

Another very important aspect of general partnerships is that any individual partner can bind the whole business to a contract or business deal—in other words, each partner has "agency authority" for the partnership. And remember, each of the partners is fully personally liable for a business deal gone sour, no matter which partner signed the contract. So choose your partners carefully.

There are also a couple of special kinds of partnerships, called limited partnerships and limited liability partnerships. They operate under very different rules and are relatively uncommon, so they are only briefly described here.

A limited partnership requires at least one general partner and at least one limited partner. The general partner has the same role as in a general partnership: the general partner controls the company's day-to-day operations and is personally liable for business debts. The limited partner contributes financially to the business (for example, by investing $100,000 in a real estate partnership) but has minimal control over business decisions or operations, and normally

cannot bind the partnership to business deals. In return for giving up management power, a limited partner gets the benefit of protection from personal liability. This means that a limited partner can't be forced to pay off business debts or claims with personal assets, but can lose an investment in the business. But beware: A limited partner who tires of being passive and starts tinkering under the hood of the business should understand that their liability can quickly become unlimited that way. If a creditor can prove that the limited partner acted in a way that led the creditor to believe that he or she was a general partner, the limited partner can be held fully and personally liable for the creditor's claims.

Another kind of partnership, called a limited liability partnership (LLP) or sometimes a registered limited liability partnership (RLLP), provides all of its owners with limited personal liability. In some states, these partnerships are available only to professionals, such as lawyers and accountants, and are particularly well suited to them. Most professionals aren't keen on general partnerships, because they don't want to be personally liable for another partner's problems—particularly those involving malpractice claims.

Forming a corporation to protect personal assets might be too much trouble, and some states won't allow these professionals to form an LLC. The solution is often a limited liability partnership. This business structure protects each partner from debts against the partnership arising from professional malpractice lawsuits against another partner. (A partner who loses a malpractice suit because of personal mistakes, however, doesn't escape liability.)

Pass-Through Taxation

Similar to a sole proprietorship, a partnership (general or limited) is not a separate tax entity from its owners; instead, it's what the IRS calls a "pass-through entity." This means the partnership itself does not pay income taxes; rather, income passes through the business to each partner, who pays taxes on a share of profit (or deducts a share of losses) on an individual income tax return (Form 1040, with Schedule E attached). However, the partnership must also issue Schedule K-1 to each partner showing their profit or loss from the partnership, plus file what the IRS calls an "informational return"—Form 1065—to let the government know how much the business earned or lost that year. This return does not require you to pay tax—just think of it as the feds letting you know they're watching.

Personal Liability for Business Debts

Because a partnership is legally inseparable from its owners, just like a sole proprietorship, general partners are personally liable for business-related obligations. What's more, in a general partnership, the business actions of any one partner bind the other partners, who can be held personally liable for those actions. So if your business partner takes out an ill-advised high-interest loan on behalf of the partnership, makes a terrible business deal, or gets in some other business mischief without your knowledge, you could be held personally responsible for any debts that result.

EXAMPLE: Jamie and Kent are partners in a profitable landscape gardening company. They've been in business for five years and have earned healthy profits, allowing them each to buy a house, decent wheels, and even a few luxuries—including Jamie's collection of garden sculptures and Kent's roomful of vintage musical instruments. One day Jamie, without telling Kent, orders a shipment of exotic poppy plants that he is sure will be a big hit with customers. But when the shipment arrives, so do agents of the federal drug enforcement agency, who confiscate the plants, claiming they could be turned into narcotics. Soon thereafter, criminal charges are filed against Jamie and Kent, resulting in several newspaper stories. Though the partners are ultimately cleared, their attorneys' fees come to $50,000 and they lose several key accounts, with the result that the business runs up hefty debts. As a general partner, Kent is personally liable for these debts even though he had nothing to do with the ill-fated poppy purchase.

Before you get too worried about personal liability, keep in mind that many small businesses don't face much of a risk of racking up large debts. For instance, if you're engaged in a low-risk enterprise, such as freelance editing, selling handmade ceramics, or offering tailoring and alteration services, your risk of facing massive debt or a huge lawsuit is pretty small. For these types of small, low-risk businesses, a good business insurance policy that covers most liability risks is almost always enough to protect owners from a catastrophe like a lawsuit or fire.

Insurance won't cover regular business debts, however. If you have significant personal assets like fat bank accounts or real estate and plan to rack up some business debt, you might want to limit your personal liability with a different business structure, such as an LLC or a corporation.

Partnership Agreements

By drafting a partnership agreement, you can structure your relationship with your partners pretty much however you want. You and your partners can establish the shares of profits (or losses) each partner will receive, the responsibilities of each partner, what will happen to the partnership if a

partner leaves, and how a number of other issues will be handled. It is not legally necessary for a partnership to have a written agreement; the simple act of two or more people doing business together creates a partnership. But only with a clear written agreement will all partners be sure of the important—and sometimes touchy—details of their business arrangement.

In the absence of a partnership agreement, your state's version of the Uniform Partnership Act (UPA) or Revised Uniform Partnership Act (RUPA) kicks in as a standard, bottom-line guide to the rights and responsibilities of each partner. Most states have adopted the UPA or RUPA in some form. In California, for example, if you don't have a partnership agreement, California's RUPA states that each partner has an equal share in the business's profits, losses, and management power. Similarly, unless you provide otherwise in a written agreement, a California partnership won't be able to add a new partner without the unanimous consent of all partners. (Cal. Corp. Code § 16401.)



RELATED TOPIC

Businesses with more than one owner should address potential changes in ownership. The partnership agreement provisions discussed in this chapter cover the very basics. Chapter 15 covers what is known as a buy-sell agreement, which establishes rules for what will happen if an owner retires, becomes disabled, dies, gets divorced, or wants to sell their interest. Buy-sell provisions can exist in a separate document or may be included in partnership agreements or other organizational documents depending on the company structure: operating agreements for LLCs or bylaws for corporations. Read Chapter 15 to become familiar with the ownership issues that can arise when your business is owned by more than one person—and how best to head off problems with a solid agreement.

There's nothing terribly complex about drafting partnership agreements. They're usually only a few pages long and cover basic issues that you've probably thought over already to some degree. Partnership agreements typically include at least the following information:

- the name of the partnership and partnership business
- the date of partnership creation
- the purpose (business) of the partnership
- contributions (cash, property, and work) of each partner to the partnership
- each partner's share of profits and losses
- provisions for taking profits out of the company (often called partners' draws)
- each partner's management power and duties
- how the partnership will handle departure of a partner, including buyout terms
- provisions for adding or expelling a partner, and
- dispute resolution procedures.

Partnership Agreement

Alison Shanley and Peder Johnson make the following partnership agreement.

Name and Purpose of Partnership

As of September 22, 20xx, Alison and Peder are the sole owners and partners of the Vermont Fly-Fishing Company. The Vermont Fly-Fishing Company shall be headquartered in Rutland, Vermont, and will sell fly-fishing equipment by mail order.

Contributions to the Partnership

Alison and Peder will make the following contributions to the partnership:

Alison Shanley	cash	$10,000
	desk, miscellaneous office furniture	1,000
	Total contribution:	$11,000
Peder Johnson	cash	$7,000
	computer system	2,000
	Total contribution:	$9,000

Profit and Loss Allocation

Alison and Peder will share business profits and losses in the same proportions as their contributions to the business.

Management of Partnership Business

Alison and Peder will have equal management powers and responsibilities.

Departure of a Partner

If either Alison or Peder leaves the partnership for any reason, including voluntary withdrawal, expulsion, or death, the remaining partner shall become the sole owner of the Vermont Fly-Fishing Company, which shall become a sole proprietorship. The remaining owner shall pay the departing partner, or the deceased departing partner's estate, the fair market value of the departing partner's share of the business as of the date of his or her departure. The partnership's accountant shall determine the fair market value of the departing partner's share of the business according to the partnership's book value.

Mediation of Disputes

Alison and Peder agree to mediate any dispute arising under this agreement with a mutually acceptable mediator.

Amendment of Agreement

This agreement may not be amended without the written consent of both partners.

Alison Shanley	Peder Johnson
Signature _____	Signature _____
Date _____	Date _____
SSN # _____	SSN # _____

These and any other terms you include in a partnership agreement can be dealt with in more or less detail. Some partnership agreements cover each topic with a sentence or two; others spend up to a few pages on each provision. You need an agreement that's appropriate for the size and formality of your business, but it's not a good idea to skimp on your partnership agreement. Don't go overboard, but also make sure you don't gloss over important details.

What a Partnership Agreement Can't Do

Although a general partnership agreement is an incredibly flexible tool for defining the ownership interests, work responsibilities, and other rights of partners, there are some things it can't do. These include:

- freeing the partners from personal liability for business debts
- restricting any partner's right to inspect the business books and records
- affecting the rights of third parties in relation to the partnership—for example, a partnership agreement that says a partner has no right to sign contracts won't affect the rights of an outsider who signs a contract with that partner, and
- eliminating or weakening the duty of trust (the fiduciary duty) each partner owes to the other partners.

Limited Liability Companies (LLCs)

Like many business owners just starting out, you might find yourself in this quandary: On one hand, having to cope with the risk of personal liability for business misfortunes scares you; on the other, you would rather not deal with the red tape of starting and operating a corporation. Fortunately for you and many other entrepreneurs, you can avoid these problems by taking advantage of a form of business called the limited liability company, commonly known as an LLC. LLCs combine the pass-through taxation of a sole proprietorship or partnership (taxes on business income are paid on each owner's individual income tax returns) with the same protection against personal liability that corporations offer.



CAUTION

Beware of special state rules. For example, California prohibits licensed professionals from organizing as an LLC (but not as a professional corporation or limited partnership). Some other states have extra LLC formalities for licensed professionals, which you can discover by asking your state licensing board.

Entrepreneur's Insight

Nancy Zastudil, Owner/Director, The Necessarian, LLC

Growing up in a family of self-starters, I had seen some of the day-to-day operations of small business but what kid ever asks, "Grandpa, what's the legal structure of your antique shop?" Well, not me. I was more interested in playing "Store," as my sister and I called it. We would take turns pretending to be the customer and the shop owner and, as many kids do, we made up the rules as we went along. As a result, our store was wildly successful, we had fabulous uniforms, and we never saved receipts.

Enter the "real" adult world: When I decided I wanted to open an art gallery, I had to be honest with myself and admit that I had no idea what I was doing in terms of actually running a business. But, as silly as it sounds, I knew that somewhere along the way, while playing Store, my intuition was taking notes.

Still, I agonized over how and where to begin, and realized that before I could do anything—ANYTHING—I needed a name and needed to establish the legal structure. I spent weeks thinking of names, listing the possibilities, and trying them out in imaginary conversations and promotional materials. This was an invaluable process because it made the business feel real before I even truly started.

Deciding on an LLC structure came, honestly, from knowing that I didn't want to have a business partner, stakeholders, or employees—at least not right away. I wanted to be solely responsible for my business but also wanted to do what I could to protect my personal assets.

Going into my fourth year of business, I can see that these decisions have served me well. The Necessarian, LLC is not yet as successful as my childhood Store but I can wear whatever I want and I know to save the receipts.

Limited Personal Liability

Generally speaking, owners of an LLC (called "members") are not personally liable for the LLC's debts. (This rule has some exceptions, discussed below.) Limited liability protects the members from legal and financial liability in case their business fails or loses a lawsuit and the business can't pay its debts. In those situations, creditors can take all of the LLC's assets, but they generally can't get at the personal assets of the LLC's members. Losing your business is no picnic, but it's a lot better to

lose only what you put into the business than to say goodbye to all that you own.

EXAMPLE: Callie forms her own one-person mail-order business, using most of her $25,000 in savings to establish a professional website and hire a marketing firm. Callie realizes that she'll have to buy a significant portion of her sales inventory up front to be able to ship goods to her customers on time, so she plans to buy those items on credit. While she is willing to risk her $25,000 investment to pursue her dream, she is worried that if her mail-order business fails, she will be buried under a pile of debt. Callie decides to form an LLC so that if her business should fail, she'll lose only the $25,000; no one will be able to sue her personally for the business debt that she owes. She feels more secure going into business knowing that even if her business fails, she can walk away without the risk of losing her house or her car.

While some LLCs opt for a structure in which the company is run by specially designated managers, most LLCs are simply managed by the members. Member management is called a "member-managed" LLC. A manager-managed LLC might be appropriate when some of the LLC's owners are passive investors (similar to limited partners), while a smaller group intends to actively run the company. When all the LLC owners intend to actively manage the company, you'll generally use the more common member-managed structure.

With this in mind, remember that, like a general partner in a partnership, any member of a member-managed LLC can legally bind the entire LLC to a contract or business transaction. In other words, each member can act as an agent of the LLC.

In manager-managed LLCs, any manager can bind the LLC to a business contract or deal.

While LLC owners enjoy limited personal liability for many of their business debts, this protection is not absolute. In several situations, an LLC owner might become personally liable for business debts or claims. However, this drawback is not unique to LLCs—the limited liability protection given to LLC members is just as strong as that enjoyed by the corporate shareholders of small corporations. Here are the main situations where LLC owners can still be held personally liable for debts:

- **Personal guarantees.** If you give a personal guarantee on a loan to the LLC, then you are personally liable for repaying that loan. Because personal guarantees are often required by banks and other lenders, this is a good reason to be a conservative borrower. Of course, if you are not required to make a personal guarantee, then only the LLC—not the members—will be liable for the debt.

- **Taxes.** The IRS or the state tax agency may go after the personal assets of LLC owners for overdue federal and state business tax debts, particularly overdue payroll taxes. Members who are active in the business are more likely than passive members to be held liable for LLC tax obligations.
- **Negligent or intentional acts.** An LLC owner who intentionally or even carelessly hurts someone will usually face personal liability. For example, if an LLC owner takes a client to lunch, has a few martinis, and injures the client in a car accident on the way home, the LLC owner can be held personally liable for the client's injuries.
- **Breach of fiduciary duty.** LLC owners have a legal duty to act in the best interest of their company and its members. This legal obligation is known as a "fiduciary duty," or is sometimes simply called a "duty of care." An LLC owner who violates this duty can be held personally liable for any damages that result from the owner's actions (or inactions). Fortunately for LLC owners, they normally will not be held personally responsible for any honest mistakes or acts of poor judgment they commit in doing their jobs. Most often, breach of duty is found only for serious indiscretions, such as fraud or other illegal behavior.
- **Blurring the boundaries between the LLC and its owners.** When owners fail to respect the separate legal existence of their LLC, but instead treat it as an extension of their personal affairs, a court may ignore the existence of the LLC and rule that the owners are personally liable for business debts and liabilities. This result is more likely to occur in one-member LLCs than in those that have several members; and even then, it happens only in extreme cases. You can easily avoid it by respecting the boundaries of your personal and business lives, by opening a separate LLC checking account, getting a federal employer identification number, keeping separate accounting books for your LLC, and funding your LLC adequately enough to be able to meet foreseeable expenses.



TIP

Planning on running a socially conscious business? A variation on LLCs, called the low-profit limited liability company, or L3C, might be for you. For details, see the "Benefit Corporations, L3Cs, and Emerging Business Structures for Socially Conscious, Mission-Driven Businesses" section later in this chapter.

LLC Taxation

Like a sole proprietorship or a partnership, an LLC is not a separate tax entity from its owners; instead, it's what the IRS calls a "pass-through entity." This means the LLC itself does not pay income taxes; instead, income passes through the business to each LLC owner, who pays taxes on the share of profit (or deducts the share of losses) on the owner's individual income tax return (for the Feds, using Form 1040 with Schedule E attached). But a multiowned LLC, like a partnership, does have to file Form 1065—an "informational return"—to let the government know how much the business earned or lost that year. LLC owners don't pay tax with this return.

LLCs give members the flexibility to choose to have the company taxed like a corporation rather than as a pass-through entity. In fact, partnerships now have this option as well. (See Chapter 9 for more about taxes.)

You might wonder why LLC owners would choose to be taxed as a corporation. After all, pass-through taxation is one of the most popular features of an LLC. The answer is that, because of the income-splitting strategy of corporations (discussed in "Corporate Taxation," below), LLC members can sometimes come out ahead by having their business taxed as a separate entity at corporate tax rates.

For example, if the owners of an LLC become successful enough to keep some profits in the business at the end of the year (or regularly need to keep significant profits in the business for upcoming expenses), paying tax at corporate tax rates can save them money. That's because federal income tax rates for corporations start at a lower rate than the rates for individuals. For this reason, many LLCs start out being taxed as partnerships, and when they make enough profit to justify keeping some in the business (rather than doling it out as salaries and bonuses), they opt for corporate-style taxation.

LLCs Versus S Corporations

Before LLCs came along, the only way all owners of a business could get limited personal liability was to form a corporation. Problem was, many entrepreneurs didn't want the hassle and expense of incorporating, not to mention the headache of dealing with corporate taxation. One easier option was to form a special type of corporation known as an S corporation, which is like a regular corporation (a C corporation) in most respects, except that business profits pass through to the owner (as in a sole proprietorship or partnership), rather than being taxed to the corporation at corporate tax rates. In other words,

S corporations offered the limited liability of a corporation with the pass-through taxation of an unincorporated entity. For a long time, this was an okay compromise for small-to-medium-sized businesses, though they still had to deal with requirements of running an S corporation (discussed in more detail below).

Now, however, LLCs offer a better option for many entrepreneurs. LLCs are indeed similar to S corporations in that they combine limited personal liability with pass-through tax status. But a significant difference between these two types of businesses is that LLCs are not bound by the many regulations that govern S corporations.

Here's a quick rundown of the major areas of difference between S corporations and LLCs. (Keep in mind that corporations, including S corporations, are explained in more detail in the next section.)

- **Ownership restrictions.** An S corporation may not have more than 75 shareholders, all of whom must be U.S. citizens or residents. This means that some of the C corporation's main benefits—namely, the ability to set up stock option and bonus plans and to bring in public capital—are pretty much out of the question for S corporations. And even if an S corporation initially meets the U.S. citizen or resident requirement, its shareholders can't sell shares to another company (like a corporation or an LLC) or a foreign citizen, on pain of losing S corporation tax status. In an LLC, any type of person or entity can become a member—a U.S. citizen, a citizen of a foreign country, another LLC, a corporation, or a limited partnership.
- **Allocation of profits and losses.** Shareholders of an S corporation must allocate profits according to the percentage of stock each owner has. For example, a 25% owner has to receive 25% of the profits (or losses), even if the owners want a different division. Owners of an LLC, on the other hand, may distribute profits (and the tax burden that goes with them) however they see fit, without regard to each member's ownership share in the company. For instance, a member of an LLC who owns 25% of the business can receive 50% of the profits if the other members agree (subject to a few IRS rules).
- **Corporate meeting and record-keeping rules.** In order for S corporation shareholders to keep their limited liability protection, they have to follow the corporate rules: issuing stock, electing officers, holding regular board of directors, and shareholders, meetings, keeping corporate minutes of all meetings, and following the

mandatory rules found in their state's corporation code. By contrast, LLC owners don't need to jump through most of these legal hoops—they just have to make sure their management team is in agreement on major decisions and go about their business.

- **Tax treatment of losses.** S corporation shareholders are at a disadvantage if their company goes into substantial debt—for instance, if it borrows money to open the business or buy real estate. An S corporation's business debt cannot be passed along to its shareholders unless they have personally cosigned and guaranteed the debt. LLC owners, on the other hand, normally can reap the tax benefits of any business debt, cosigned or not.

This can translate into a nice tax break for owners of LLCs that carry debt.

Forming an LLC

To form an LLC, you must file Articles of Organization with your Secretary of State or other LLC filing office. You should also execute an operating agreement, which governs the internal workings of your LLC. Also, be aware that an LLC might not be as cheap to start as a partnership or sole proprietorship. A few states charge significant filing fees, plus annual dues (alternately called minimum taxes, annual fees, or renewal fees). These fees can push the costs of starting an LLC into the several-hundred-dollar range. Massachusetts, for instance, charges a $500 fee to file a Certificate of Organization, and California requires that you pay a minimum annual LLC tax of $800 when you start your LLC—on top of its $70 filing fee.

Many brand-new business owners aren't in a position to pay this kind of money right out of the starting gate, so they start out as partnerships until they bring in enough income to cover these costs. And if you're thinking of forming a corporation instead, keep in mind that most states charge at least as much in fees for corporations. The hefty formation cost, plus the added expenses of running a corporation (legal and accounting fees, for example) will almost always make a corporation more expensive to run than an LLC.



CAUTION

Some LLCs must comply with securities laws. LLCs that have owners who do not actively participate in the business may have to register their membership interests as securities or, more likely, qualify for an exemption to the registration requirements. For information about exemptions to the federal securities laws, visit the Securities and Exchange Commission's website at www.sec.gov and search "Information For: Small Businesses."



RESOURCE

For more on LLCs. Your Secretary of State or other LLC filing office will have lots of information on LLC rules and procedures in your state. To find yours, search online for "[your state] LLC filing." You can also learn more from Nolo's LLC books, including *Nolo's Quick LLC: All You Need to Know About Limited Liability Companies*, by Anthony Mancuso; and *Nolo's Guide to Single-Member LLCs*, by David M. Steingold. Nolo also offers an online 50-state guide to forming an LLC (with the requirements for each state) and a comprehensive LLC package to form your LLC online (see www.nolo.com for details).

Corporations

For many, the term "corporation" conjures up the image of a massive industrial empire more akin to a nation-state than a small business. In fact, a corporation doesn't have to be huge, and most aren't. Stripped to its essentials, a corporation is simply a legal structure that imposes certain legal and tax rules on its owners (also called shareholders). A corporation can be as large as Microsoft or, in many cases, as small as one person.

One fundamental legal characteristic of a corporation is that, like an LLC (but unlike a sole proprietorship or partnership), a corporation is a separate legal entity from its owners. Another important corporate feature is that shareholders are normally protected from personal liability for business debts. Finally, the corporation itself—not just the shareholders—is subject to income tax on corporate profits.



SEE AN EXPERT

Publicly traded corporations are a different ball game. This section discusses privately held corporations owned by a small group of people who are actively involved in running the business. These corporations are much easier to manage than public corporations, whose shares are sold to the public at large. Any corporation that sells its stock to the general public is heavily regulated by state and federal securities laws. But corporations that sell shares, without advertising, to only a select group of people who meet specific state requirements are often exempt from many of these laws. If you plan to sell shares of a corporation to the general public, you should consult a lawyer.

Limited Personal Liability

Generally speaking, owners of a corporation are not personally liable for the corporation's debts. (There are some exceptions to this rule, discussed below.) Limited personal liability is a major reason why owners have traditionally chosen to incorporate their business: to protect themselves from legal and financial liability in case their business flounders or loses an expensive lawsuit and can't

pay its debts. In those situations, creditors can take all of the corporation's assets (including the shareholders' investments), but they generally can't get at the personal assets of the shareholders.

EXAMPLE: Tim and Chris publish *Tropics Tripping*, a monthly travel magazine with a focus on Latin America. Because they both have significant personal assets, and because they will have to borrow a lot of capital to start up their magazine, they form their business as a corporation to protect their personal assets in case their magazine fails. Business is great for a few years, but suddenly their subscription and advertising revenue starts to suffer when a recession plus political unrest in several Latin American countries reduce interest in travel to that area. Hoping the situation will turn itself around, Tim and Chris forge ahead—and go deeper into debt as it proves impossible to pay printing and other bills on time. Finally, when their printer won't do any more print runs on credit, Tim and Chris are forced to call it quits. *Tropics Tripping*'s debts total $250,000, while business assets are valued at only $90,000—leaving a $160,000 debt to creditors. Thankfully for Tim and Chris, they won't have to use their personal assets to pay the $160,000, because, as owners of a corporation, they're shielded from personal liability.



TIP

Corporations aren't the only option. With the advent of limited liability companies, corporations aren't the only business entities that provide limited liability status for all owners. (See the section on LLCs, above.)

Forming a corporation to shield yourself from personal liability for business obligations provides good, but not complete, protection for your personal assets. Here are the principal areas in which corporation owners still face personal liability:

- **Personal guarantees.** If you give a personal guarantee on a loan to the corporation, then you are personally liable for the repayment of that loan. Because lenders often require a personal guarantee, this is a good reason to be a conservative borrower. Of course, if the owners do not make personal guarantees, only the corporation—not the shareholders—is liable for the debt.
- **Taxes.** The IRS or the state's tax agency may go after the personal assets of corporate owners for overdue corporate federal and state tax debts, particularly overdue payroll taxes. In small corporations, shareholders who have an active hand in managing the business are more likely than passive shareholders to be liable for unpaid corporate taxes.
- **Negligent or intentional acts.** A corporate owner who negligently (that is, carelessly) or perhaps even intentionally ends up hurting someone can't hide behind the corporate barrier to escape personal liability. Shareholders are subject to personal liability for wrongs they commit—such as attacking a customer or leaving a floor wet in a store—that result in injury.

- **Breach of fiduciary duty.** Corporate owners have a legal duty to act in the best interest of the company and its shareholders. This legal obligation is known as a "fiduciary duty," sometimes simply called a "duty of care." If an owner violates this duty, the owner can be held personally liable for any damages that result from their actions (or inactions). Fortunately for corporate owners, run-of-the-mill mistakes or lapses in judgment aren't usually considered breaches of the duty of care. Most often, breach of duty is found only for serious indiscretions, such as fraud or other illegal behavior. For example, if a corporate officer ignored repeated warnings and written reports that one of its manufacturers was using toxic ingredients in the pet products sold by the corporation, that officer could be held personally liable for any damages that result from that breach of duty to the company.
- **Blurring the boundaries between the corporation and its owners.** When corporate owners ignore corporate formalities and treat the corporation like an unincorporated business, a court may ignore the existence of the corporation (in legal slang, "pierce the corporate veil") and rule that the owners are personally liable for business debts and liabilities. To avoid this, it's important that corporate owners not allow the legal boundary between the corporation and its owners to grow fuzzy. Owners need to scrupulously respect corporate formalities by holding shareholders and directors meetings, keeping attentive minutes, issuing stock certificates, and maintaining corporate accounts strictly separate from personal funds.

Also, bear in mind that while limited personal liability can prevent you from losing your home, car, bank account, and other assets, it won't protect you from losing your investment in your business. A business can quickly get wiped out if a customer, an employee, or a supplier wins a big lawsuit against it and the business has to be liquidated to cover the debt. In short, even if you incorporate to protect your personal assets, you should purchase appropriate insurance to protect your business assets. (Insurance is discussed in Chapter 8.) But remember, insurance won't help if you simply can't pay your normal business debts.

Corporate Taxation

The words "corporate taxes" raise a lot of fear and loathing in the business world. Fortunately, the reality of corporate taxation is usually less depressing than its reputation. Here are the basics—think of it as Corporate Tax Lite. If you decide to incorporate, you'll likely want to consult an accountant or a small business lawyer who can fill you in on the fine points. (See Chapter 17 for information on finding and hiring a lawyer.)

The first thing you need to know is that how you'll be treated for tax purposes will depend on whether you operate as a regular corporation (also called a C corporation) or have elected S corporation status for tax purposes. An S corporation is the same as a C corporation in most respects, but when it comes to taxes, C and S corporations are very different animals.

A regular, or C, corporation must pay taxes, while an S corporation is treated like a partnership for tax purposes and doesn't pay any income taxes itself. Like partnership profits, S corporation profits (and losses) pass through to the shareholders, who report them on their individual returns. (In this respect, S corporations are very similar to LLCs, which also offer limited liability, along with partnership-style tax treatment.) These two types of corporations are explained in more detail just below.

C Corporations

As a separate tax entity, a regular corporation must file and pay income taxes on its own tax return, much like an individual does. After deductions for things like employee compensation, fringe benefits, and all other reasonable and necessary business expenses have been subtracted from its earnings, a corporation pays tax on whatever profit remains.

In small corporations in which all of the owners of the business are also employees, all of the corporation's profits are often paid out in tax-deductible salaries and fringe benefits—leaving no corporate profit and, thus, no corporate taxes due. (The owner and employees must, of course, pay income tax on their salaries on their individual returns.)

Since 2018, the corporate tax rate has been a flat 21% for all corporations. This low rate, plus the simple structure, can make C corporations more attractive to even very small businesses.

Fringes and Perks

Corporations can deduct many fringe benefits as business expenses, just as they do with employee salaries. If a corporation pays for benefits such as health and disability insurance for its employees and owner/employees, the cost can usually be deducted from the corporate income, reducing a possible tax bill. (There's one main exception: Benefits given to an owner/employee of an S corporation who owns 2% or more of the stock can't be deducted as business expenses.)

As a general rule, owners of sole proprietorships, partnerships, and LLCs can deduct the cost of providing these benefits for employees, but not for themselves. (These owners can, however, deduct a portion of their medical insurance premiums on their personal tax returns, though it's technically a deduction for the individuals, not a business expense.)

An owner's ability to deduct the cost of fringe benefits for themselves might make incorporating a wise choice. But it's less likely to be a winning strategy for a capital-poor start-up that can't afford to underwrite a benefits package.

Double Taxation

One vexing issue faced by large corporations with shareholders who aren't active employees is double taxation. Unlike salaries and bonuses, dividends paid to shareholders cannot be deducted as business expenses from corporate earnings. Because they're not deducted, any amounts paid as dividends are included in the total corporate profit and taxed. And when the shareholder receives the dividend, it is taxed at the shareholder's individual tax rate as part of personal income. As you can see, any money paid out as a dividend gets taxed twice: once at the corporate level, and once at the individual level.

You can avoid double taxation simply by not paying dividends. This is usually easy if all shareholders are employees, but probably more difficult if some shareholders are passive investors anxious for a reasonable return on their investments.

S Corporations

As discussed above, an S corporation, unlike a C corporation, does not pay taxes. Any profits pass through to the owners, who pay taxes on income (though owners of pass-through entities can deduct 20% of qualified business income; see Chapter 9 for details). Yet the business is still a corporation giving its owners protection from personal liability for business debts, just like shareholders of C corporations and members (owners) of LLCs.

Until the relatively recent arrival of the LLC (discussed above), the S corporation

was the business form of choice for those who wanted limited liability protection without the two-tiered tax structure of a C corporation. Today, LLCs are a popular alternative, because S corporations are subject to many regulations that do not apply to LLCs. (See "LLCs Versus S Corporations," earlier in this chapter, for more information.)

Forming and Running a Corporation

In addition to tax complexity, major drawbacks to forming a corporation—either a C or an S type—are time and expense. Unlike with sole proprietorships and partnerships, you can't clap your hands twice and conjure up a corporation. To incorporate, you must file articles of incorporation with your Secretary of State or other corporate filing office, along with often hefty filing fees and minimum annual taxes. And if you decide to sell shares of the corporation to the public—as opposed to keeping them in the hands of a relatively small number of owners—you'll have to comply with lots of complex federal and state securities laws.

Finally, to protect your limited personal liability, you need to act like a corporation, which means adopting bylaws, issuing stock to shareholders, maintaining records of various meetings of directors and shareholders, and keeping records and transactions of the business separate from those of the owners.



CAUTION

Corporations must comply with securities laws. Corporations must either register their shares with the Securities and Exchange Commission or qualify for an exemption to securities registration requirements. For information about small business exemptions to the federal securities laws, visit the Securities and Exchange Commission's website, at sec.gov.

To sum up, the protection afforded by incorporating comes at a price. Figure in the likelihood that you'll have to hire lawyers, accountants, and other professionals to keep your corporation in compliance, and it's easy to see how expensive running a corporation can be.



RESOURCE

Recommended reading on corporations. For more information on the many complexities of running a corporation, read *The Corporate Records Handbook: Meetings, Minutes & Resolutions*, by Anthony Mancuso (Nolo).

Benefit Corporations, L3Cs, and Emerging Business Structures for Socially Conscious, Mission-Driven Businesses

Entrepreneurs who start businesses that want to emphasize sustainability or other goals in the public interest sometimes wonder whether they should form a regular

for-profit business or a nonprofit. The nonprofit structure, however, is fundamentally different from a for-profit business, and business owners might find it too constraining on important issues such as being able to take profits and needing to manage the business with a board of directors.

In recent years, businesses in many states have some new options that are like a for-profit/nonprofit hybrid. Three new structures are benefit corporations, Certified B Corps, and L3Cs. Let's take a look at each one.



RESOURCE

The basics of starting a nonprofit. *Starting & Building a Nonprofit,* by Peri Pakroo (Nolo) provides step-by-step advice on getting a nonprofit up and running, from developing a mission and strategic plan to recruiting and managing board members. Also, check out the "Nonprofits" section of Nolo.com for dozens of articles on the subject.

Benefit Corporations

A benefit corporation is legally required to prioritize making a positive social impact in addition to making profits for shareholders. Structuring as a benefit corporation might be appealing for businesses that want to incorporate a social mission into the core of their business.

A benefit corporation features the following elements:

- The corporation's *purpose* is to create a material positive impact on society and the environment.
- The corporation is *accountable* through a fiduciary duty not only to corporate shareholders, but also to workers, community, and the environment.
- The corporation is run *transparently*, and must publish public annual reports on overall social and environmental performance, measured against an independent and transparent third-party standard.

As of mid-2023, roughly 35 states and the District of Columbia allow benefit corporations. To find out if your state has authorized the benefit corporation entity, check with your Secretary of State.

Certified B Corps

Benefit corporations are virtually identical to another structure called a Certified B Corp, which is a business that has been assessed and certified to meet sustainability-related criteria by B Lab, a nonprofit. The difference between benefit corporations and Certified B Corps is just that benefit corporations are an actual corporate structure recognized by the state, while the Certified B Corp is a certification conferred by a nonprofit.

If you live in a state that does not recognize benefit corporations, you can still seek to be certified as a Certified B Corp. For more information, check out B Lab's website at www.bcorporation.net.

Low-Profit Limited Liability Companies (L3Cs)

Another hybrid business structure available in some states is the low-profit limited liability company, or L3C. An L3C is similar to a nonprofit in that its primary purpose must be to benefit the public. But an L3C is run like a regular profit-making business and is allowed to make a profit as a secondary goal. This type of business structure was born so that charitably oriented LLCs could receive seed money (specifically, "program-related investments," or PRIs) from large nonprofit foundations, taking advantage of IRS rules that allow foundations to invest in businesses principally formed to advance charitable purposes.

Only a small number of states allow L3Cs, including Illinois, Kansas, Louisiana, Maine, Michigan, Missouri, North Dakota, Rhode Island, Utah, Vermont, and Wyoming. The structure has also been adopted by the tribal governments of the Oglala Sioux Tribe and the Crow Indian Nation of Montana, and the territory of Puerto Rico. As of mid-2023, there does not appear to be much momentum behind this structure, so it's unclear what the future holds.

In 2016, the IRS issued regulations for examples of investments that qualify as PRIs, and it notably declined to include L3Cs in the examples. This omission is likely to make foundations even more skittish to invest in L3Cs, and puts the future of this structure in doubt. Stay tuned for future developments.

Choosing the Best Structure for Your Business

Although there are many differences among the various types of business organizations, most business owners choose an operating structure based on one legal issue: the personal liability of owners for business debts.

Certainly, owners of any business that will engage in a high-risk activity, rack up large business debts, or have a significant number of investors should always insist on limited personal liability, with either an LLC or a corporation. This is even more true if the business can't find or afford appropriate insurance.

Analyzing Your Risks

Starting a business is always at least a bit risky. In some businesses, however, the risks are particularly extreme. If you're planning to launch an investment firm or start a commercial building construction company, there is little doubt that you'll need all the protection you can get, including limited personal liability as well as adequate insurance. Other businesses are not so obviously risk-laden, but still could land you in trouble if fate strikes you a blow. When analyzing your business, note that red flags for riskiness include:

- using hazardous materials, such as dry cleaning solvents or photographic chemicals, or hazardous processes, such as welding or operating heavy machinery
- manufacturing or selling edible goods
- driving as part of the job
- building or repairing structures or vehicles
- advising clients on professional topics such as financial management
- providing health care for patients, including physical and mental health
- caring for children or animals
- providing or allowing access to alcohol
- allowing activities that may result in injury, such as weightlifting or skateboarding, and
- repairing or working on items of value, such as cars or antiques.

If you've identified one or more serious risks your business is likely to face, figure out whether business insurance might give you enough protection. Some risky activities, such as job-related driving, are good candidates for insurance and don't necessarily warrant incorporating. But if insurance can't cover all of the risks involved in your business, it might be time to form an LLC or a corporation.

Keep in mind that insurance does not typically insulate you from regular business debts. Business interruption insurance is an exception, as long as the cause of the disruption—say, you close for COVID-related reasons—is covered by the policy. If you foresee your business going into serious debt, an LLC or corporation might be the best business structure for you.

If you decide that creating an entity to limit your personal liability is the way to go, you still need to decide whether to form a corporation or an LLC. With the LLC's arrival, many business owners who want limited liability protection realize that incorporation normally makes sense only if a business needs to take advantage of the corporate stock structure to attract key employees and investment capital. No question, corporations might have an easier time attracting capital investment by issuing stock privately or publicly.



SEE AN EXPERT

Location matters. Another important consideration in choosing your business structure can be related to the state you choose to locate it in, especially if you are going into business with people who do not live in your state. This is because states differ widely in how they tax different business entities and nonresident business owners. There can be big state tax complications when a business either operates in more than one state or has owners in more than one state. A tax attorney can tell you whether you can reduce your taxes and increase profits by choosing one state over the other as your headquarters. More information on location-related issues is included in Chapter 3.

Also, some businesses might find it easier to attract and retain key employees by issuing employee stock options. But for businesses that don't intend to raise capital by issuing stock, choosing to operate as LLCs rather than corporations normally makes the most sense when limited liability is the main concern. If the corporate stock structure isn't something you want or need for your business, the simplicity and flexibility of LLCs offer a clear advantage over corporations.

Chapter 1 Checklist: Choosing a Legal Structure

- ☐ Identify the number of owners of your business.
- ☐ Analyze your business's risks and decide how much protection from personal liability you'll need.
- ☐ Determine how you'd like the business to be taxed (as a pass-through entity or as a corporation).
- ☐ Decide if your business would benefit from the stock structure of a corporation (by being able to distribute stock options and sell stock).
- ☐ Choose a business structure.
- ☐ If you will structure your business as a partnership, draft and sign a partnership agreement.

CHAPTER 2

Picking a Winning Business Name

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There's a lot of room for personal and professional creativity when picking a business name, but you will absolutely need to understand various legal requirements and pitfalls. In particular, it's important for all business owners to know the basics of trademark law, which establishes and protects the legal right to use a particular name for businesses, products, or services.

If you choose a business or product name that's too similar to a competitor's name, you could find yourself accused of violating the competitor's trademark (called "infringement" or "unfair competition"), and you could be forced to change your business name and possibly pay money damages. Having to change a business name can be a serious blow to a business that has worked hard to build name recognition among its customers—not to mention the cost of changing signs, stationery, preprinted invoices, and the like.

But suppose you plan to open a local business so small that you don't even expect to compete with businesses in the next county, much less in another state or country. You probably wonder if the arcane world of trademark law really affects you. Until the 1990s, the answer would likely have been no—you didn't really have to worry too much about national or global name conflicts back then. As long as a quick search of your phone book didn't reveal any obvious local conflicts and you didn't call your business "Ford," "IBM," or some other famous name, you were probably fine. But in today's digitally connected world, "local" obviously isn't what it used to be. Even if you're opening just a tiny bookstore in a small town, if you inadvertently choose the same name as an online store that sells books, you may very well be accused of infringing the online store's trademark—even if its headquarters are on a different continent.

One good way to figure out how concerned you need to be about trademark law is to consider the consequences of having to change your business name. If a name change would be cheap and easy and wouldn't seriously confuse your customers, then don't lie awake nights worrying about picking a name that's absolutely bulletproof. However, if changing your name would be messy or expensive (changing signs, ads, your domain name, and business directory listings, to mention a few possibilities), take the time and trouble to be sure the name you plan to use doesn't already belong to someone else.

Are you convinced that paying attention to the law of business names is important? Good. Now you'll learn how to choose a name that won't land you in legal hot water and how to secure the maximum

legal protection for it. This chapter will also cover some nonlegal aspects of naming your business, including tips and advice on how to choose the most effective name for your business.



CAUTION

Watch out for other legal issues. Besides watching out for trademark conflicts, business owners also need to comply with other legal rules. Many businesses must comply with their county's fictitious business name requirements. (See Chapter 7 for information on registering a fictitious business name.) Typically, this means you'll need to register a fictitious business name statement (or similar document) with your county clerk and possibly publish it in a local newspaper. For corporations, LLCs, and limited partnerships, the state filing office (usually the Secretary or Department of State) must approve your business name before it will accept articles of incorporation, articles of organization, or a statement of limited partnership.

An Overview of Trademark Law

In a nutshell, trademark law prevents a business from using a name or logo that is likely to be confused with one that a competing business already uses. This general rule applies both to the name of a business and to the names of any of its products or services.

Trademark Protects More Than Names

This chapter focuses on how trademark applies to business names. But the rules discussed here apply to a lot more—logos, designs, slogans, and packaging features can also be protected by trademark. For example, Nike's slogan, "Just Do It," and American Express's mantra, "Don't leave home without it," are protected by the law of trademark.

Allowing businesses to have exclusive use of certain names helps consumers to identify and recognize goods in the marketplace. When you buy Racafrax brand of wood glue, for instance, you'll know that it will be similar in quality to the Racafrax glue you bought last time. By contrast, if any company were allowed to call its glue "Racafrax Glue," customers would never know what they were getting. And because customers would never know when they were using the Racafrax company's glue, the Racafrax company wouldn't be able to build customer trust or goodwill, even if its glue was the best available. In this way, consumers and businesses alike benefit from trademark protection.

This section will give you a rundown of what's protected by trademark law and how to determine and protect your rights to the names you use. This overview will help you understand what steps you should

Business Names: Getting the Terms Straight

One reason the law of business names can seem confusing is that it is riddled with lots of arcane and often overlapping legal jargon. For example, local, state, and federal agencies often use different terms to describe the same or very similar legal concepts. Here's a brief rundown of the terms you need to know, all of which are discussed in greater detail in the rest of this chapter:

- The term **legal name** means the official name of the entity that owns a business. The legal name of a sole proprietorship is simply the full name of the owner—for example, Jodie Potter. If a general partnership has a written partnership agreement that gives a name to the partnership, then that name is the legal name. Otherwise, the legal name of the general partnership is simply the last names of the owners. (Many sole proprietorships and partnerships present their businesses to the public under names that are different from their legal names—see fictitious business names, below.) And for corporations, LLCs, and limited partnerships, legal names are the names registered with the state filing office (usually the Secretary of State). For these businesses, the terms corporate name, LLC name, and limited partnership name can be used to mean legal name.
- A **trade name** is simply the name that a business uses with the public, which may or may not be the same as the name of the business owner or the business's legal name. Trader Joe's, Amoeba Music, and Nolo are examples of trade names. You see trade names on business signs, on websites, and on invoices. In many transactions, such as when you open a bank account or apply for a loan, you'll need to provide the owners' names, the legal name of the business (if different), and the trade name of the business (if different).
- The term **fictitious business name** is used when the trade name of a business is different from its legal name. For instance, if John O'Toole named his sole proprietorship Turtle's Classic Cars, the name "Turtle's Classic Cars" would be a fictitious business name because it does not contain the owner's last name, "O'Toole." A fictitious business name is sometimes called a **DBA** name. DBA stands for "doing business as," as in "John O'Toole, doing business as Turtle's Classic Cars." Corporations and LLCs might also have to file fictitious name statements if the names they hold out to the public differ from the legal names they registered with the state. For example, if the owners of Corson Mechanics Incorporated decide to operate a repair shop under the fictitious name "Grease Monkeys," they'll have to file a fictitious business name statement.

Business Names: Getting the Terms Straight (continued)

- A **trademark** (sometimes simply called a mark) is any word, phrase, design, or symbol used to market a product or service Technically, a mark that's used to market a service, rather than a product, is called a service mark, though the term "trademark" is commonly used for both types of marks. Owners of trademarks have legal rights under both federal and state law, which give them the power in some cases to prevent others from using their trademarks to market goods or services.

take as part of forming your business to avoid infringing others' rights (and opening yourself up to lawsuits). And it will also give you the legal basics you'll need to protect your business name and to figure out whether your rights are being infringed by others down the road.



CAUTION

Pick a name that won't bring legal trouble. The main reason to learn the basics of trademark law is not so you can successfully defend your name in court against another business that tries to use it. Even if you were to win a complex and expensive court fight, you'd be a huge loser when it comes to time, worry, and legal fees. Far better to avoid disputes in the first place by choosing a safe name that has a very low likelihood of leading to customer confusion and, therefore, an infringement lawsuit.

What Is a Trademark?

The definition of "trademark" is simple: Any word, phrase, logo, or other device used to identify products or services in the marketplace is a trademark. This includes the names of products or services themselves and often the name of the business that's selling them. Using a name in public commerce to identify goods or services for sale is enough to make it a trademark; there is no registration requirement. However, registration with the U.S. Patent and Trademark Office will greatly strengthen your power to enforce your rights in the trademark. For example, if you federally register your trademark, you can stop any subsequent user in your field from using the same or a confusingly similar mark anywhere in the United States. (See "Trademark Registration," later in this chapter.)

Business Names and Trademarks Often Overlap

Many trade names double as trademarks and service marks for products and services of the business. For instance, when McDonald's (trade name) advertises McDonald's French fries, the trade name "McDonald's" also becomes a trademark because it is used to identify the maker (or brand) of French fries. And when the company puts up a sign in front of its restaurant, the term "McDonald's" becomes a service mark, identifying who's providing the fast food service of that restaurant. In other words, any time you use your trade name to identify a product, service, or business location, you're using the trade name as a mark—either a trademark or a service mark. As you can see, a name can wear a bunch of different hats: It can be a trade name, a legal name, and a trademark (or service mark) all in one.

Legal Name	Trade Name	Trademarks/Service Marks
McDonald's Corporation	McDonald's	McDonald's French fries Big Mac Mayor McCheese Golden arches symbol
Microsoft Corporation	Microsoft	Microsoft *Word* Bing search engine "Where do you want to go today?" slogan
Trader Joe's Company	Trader Joe's	Trader Joe's Baked Tortilla Chips Trader Giotto's Italian Roast coffee beans Trader Darwin's vitamins
Ronco, Inc.	Ronco	Popeil Pocket Fisherman Dial-O-Matic Food Slicer
Kraft Foods, Inc.	Kraft	JELL-O Gelatin Cheez Whiz Tang Drink Mix "It's the cheesiest" slogan for Kraft Macaroni & Cheese "Good to the last drop" slogan for Kraft Maxwell House Coffee

Keep in mind, however, that a key part of the definition of a trademark is that it must be used in public commerce to identify goods or services for sale. So if you don't use the name of your business or product or service in public in conjunction with something you're trying to sell, it isn't considered a trademark.

EXAMPLE: A software company called ZZP Web Masters markets bookmarking software for the internet called "WebWorm," If ZZP Web Masters markets only the name WebWorm, then only WebWorm is a trademark. If they want to trademark the business name, they need to associate it with the product. They could do this by advertising the two names together, such as in an ad that reads, "WebWorm: The best bookmarking software on Earth, by ZZP Web Masters." This ad establishes ZZP Web Masters as the source of WebWorm, which constitutes use in commerce and qualifies ZZP Web Masters as a trademark (in addition to WebWorm).

A name that appears only in nonpublic documents—such as an internal memo or a product sample that isn't available to the public—isn't a trademark.

For practical purposes, many if not most business names are also considered trademarks, because most businesses do use their names to promote or sell their product or service.

Trademarks Versus Service Marks

You've probably heard the term "trademark," which applies to names, logos, and slogans that identify products (such as Chia Pet), a whole lot more than the term "service mark," which is used when a name identifies a service (such as H&R Block Tax Preparation Services). Because the legal rules for trademarks and service marks are virtually identical, the term "trademark," or sometimes just "mark," is commonly used for both types of marks. But because the two terms do refer to technically different things, you should be aware of the distinction, especially if your business will primarily provide services.

Trademark Rights

The power of a trademark comes from your ability to exclude others from using the same mark. If you were the first to use the trademark, you own certain rights to it and can take legal action against others who use it illegally. In legal terms, if others "infringe your trademark" by using it in a way that's likely to confuse your customers or that has "diluted" your trademark, you can take them to court and force them to stop using it, and maybe even to pay damages.

For example, if ZZP Web Masters had been selling an app called WebWorm for two years and then another company started selling a similar software product called WebWorm, ZZP Web Masters could sue the other company and force it to stop using the product name "WebWorm." If ZZP Web Masters could prove that its business suffered because of the infringement, it might also be entitled to some financial compensation (damages) from the other company.

So far, so good—you're probably even wondering why everyone says trademark issues are such a bear to deal with. Here's why: Just because you own a trademark doesn't mean you can always prevent someone else from using it (and, likewise, another owner of a trademark can't always prevent you from using that mark). Unlike a copyright, which generally gives the same level of protection to all owners, a trademark gives widely varying degrees of protection to the owner, depending on a variety of circumstances. So, as explained below, the key legal point isn't so much whether you own a trademark but whether it qualifies for trademark protection—and, if so, how much.

Strong Versus Weak Marks

The general rule is that distinctive business names receive the strongest legal trademark protection. What makes a mark "distinctive" is explained in more detail below, but, for the moment, it's important that you understand why distinctive names get more protection. The theory is that distinctive names, such as Pepsi or Xerox, make strong connections in the minds of consumers, and play a big role in consumers' buying choices. The opposite is considered to be true for names that aren't very distinctive, such as Quality Vitamins or Brite Paint.

Because distinctive names are thought to play such a big role in helping consumers choose among brands, it follows that the more distinctive a name is, the more likely it is that customers will be confused (in legal theory at least) by more than one business using the name. To avoid this confusion, the law gives more protection to distinctive names, and less or none to names that are merely ordinary and descriptive.

A truly distinctive trademark (also called a "strong trademark") is one that clearly distinguishes the product or service it represents from others. Memorable, unusual names tend to be considered distinctive marks. While there's no magic formula for what makes a trademark distinctive, strong marks are often surprising or fanciful names that have nothing to do with the business, product, or service. Examples include Google, Nike, Velcro, and Spotify.

On the flip side, a weak trademark consists of ordinary, descriptive words that merely describe aspects of the product or business, such as durability ("Sturdy Knapsacks"), location ("The Edge of Town Tavern"), or other qualities ("Speedy Dry Cleaners" or "Tasty Cookies"). Also, trademarks that include personal names are usually considered to be ordinary marks and, therefore, weak. (But, as explained below, weak trademarks can become stronger with use.)

An additional reason why ordinary, descriptive trademarks aren't strongly protected, at least at first, is to make sure that competitors aren't unfairly prevented from using common words to describe their own products. For example, a food delivery service company called "Galloping Gourmet" wouldn't be able to monopolize the word "gourmet" and stop a deli from using the name "Tom's Gourmet Sandwiches."

How Trademarks Can Grow Stronger

A weak trademark can eventually offer good protection if it becomes distinctive and therefore stronger through use. Called "acquiring a secondary meaning" in legalese, this is particularly likely to occur when a product or service with a weak mark becomes a lasting success, making it likely that the public will associate the mark with the product or service being sold. For example, as the designer clothing brand Tommy Hilfiger became popular nationwide, its previously weak trademark grew stronger as customers came to associate the ordinary name with a particular company. Other examples of the weak-to-strong phenomenon include Burger King, Tom's Natural Toothpaste, and Ben & Jerry's Ice Cream.

Unfair Competition Laws

What if your weak trademark never becomes strong? Just because you have a weak trademark doesn't mean that others are free to use your business name. Because of a legal doctrine called "unfair competition," you might be able to prevent others from using your descriptive name, so long as you used it first. Although unfair competition law is a separate body of law from trademark law, it can have the same effect. It comes from the same basic idea that it's not fair for another business to benefit from your business's good reputation.

For example, if you've been selling dry cleaning services in Bakersfield under the name Jean's Quick Cleaners, and someone else in the same city opens Jeanne's Quick Cleaners, you could claim unfair competition and likely convince a court to prevent the newcomer from using that

name. As you can see, unfair competition law can have the same result as trademark law: It can prevent another business from using a name identical or confusingly similar to yours, if you used the name first. Keep in mind, however, that your right to stop trademark infringement is stronger than your right to stop unfair competition, so it will be easier to prevent someone from using your business name if it's a strong trademark.

When Do Trademarks Conflict?

As you surely know, plenty of businesses share the same name, or at least part of the same name, without violating each other's trademark rights. Examples include United Airlines and United Van Lines, Ford Motor Company and Ford Modeling Agency, and Scott Paper Products and Scott Sunglasses. This is perfectly legal, because trademark infringement occurs only when the use of a mark by two different businesses is likely to cause customer confusion. (An exception to this rule is explained in "The Dilution Exception," below.) If customers aren't likely to be confused, both businesses may legally use the same mark. But if customer confusion is likely, the rightful owner of the mark can prohibit the other businesses from using it, and can sue for damages (financial compensation) for any unauthorized use.

Dual uses of the same or similar mark can cause customer confusion when it's unclear which company actually makes a product or provides a service, or if customers will be misled as to the source of the product. Customer confusion can happen in a number of different ways. Sometimes dual uses of a mark lead customers to believe that a certain company made a product when it actually did not. Or a customer might see a trademark being used in different places and think that the companies are jointly owned or somehow affiliated, which might not be true.

Determining whether two marks legally conflict (in other words, whether customer confusion is likely) is one of the trickiest bits of trademark law. In making this determination, courts consider the following questions:

- How strong (distinctive or well known) is the original trademark?
- How much do the products or services really compete against one another?
- How similar are the trademarks in appearance, sound, or meaning?

We'll look at each question in more depth in the next few sections. As you read on, keep in mind that resolving a trademark conflict involves applying legal rules, as opposed to common sense.

How "Strong" Is the Mark?

As discussed above, distinctive ("strong") marks receive the most protection because, in legal theory, they are more likely to stick in consumers' minds and play a role in their buying choices.

Because strong trademarks tend to stick in customers' minds, so the theory goes, customer confusion is likely if more than one company uses a strong trademark. To protect consumers from such confusion, courts will typically prohibit more than one company from using a strong trademark. Besides protecting consumers, prohibiting multiple uses of a strong trademark prevents businesses from stealing customers or getting a free ride off another business's good reputation.

For example, the very strong and well-known trademark Microsoft is firmly implanted in millions of people's minds. If a company called itself Microsoft Consulting, plenty of people would be confused about whether Microsoft, the software company, had anything to do with that consulting company. If the software company Microsoft sued Microsoft Consulting for trademark infringement, they would have a very good chance of winning.

Trademark law doesn't give much, if any, protection to weak trademarks, because they don't trigger a strong association in customers' minds between the mark and a particular product or service (or so the legal thinking goes). For that reason, courts are less inclined to find that customer confusion is likely when more than one business uses a weak trademark. Note that this is true even if customer confusion does in fact exist.

For example, if Smith Jewelry and Smith Hardware exist in the same town, customers might wonder whether they're owned by the same family. Nevertheless, trademark law won't protect the name of either business, because the name Smith is so common. (However, unfair competition law might protect the hardware store Smiths if the jewelry store Smiths started getting into the hardware business, making the businesses direct competitors.)

Do the Products or Services Actually Compete?

If the products or services that share the same trademarks are in completely unrelated fields or industries, or if they're sold in different geographical regions (and not on the internet), there's obviously far less chance that customers will be confused. In other words, the less products or services actually compete, the less likely it is that there will be a trademark violation.

For example, a pizza joint named Rocket Pizza probably won't be confused with a record store named Rocket Records, even if they exist in the same city. And an auto shop named Armadillo Repairs in Portland, Maine, most likely won't run into any trademark conflicts with Armadillo Auto Repairs in San Diego. Because the businesses are so far apart and serve purely local customers, chances are slim that customers would confuse the two companies.

EXAMPLE: You open a coffee shop in Austin, Texas, and name it Pam's Coffee Stop. A year later, you're driving through Albuquerque, New Mexico, and notice a small café also named Pam's Coffee Stop. After thinking about it, you decide that there's little chance of a trademark violation by either business. The trademark is ordinary and descriptive and therefore weak, plus the shops are so far away from each other that they're not competitors. But this gets you wondering what you'd do if a big national chain started using the name and moved into your area. The answer is, you would retain the right to use the name because you were the first to use it in your area (as long as the national chain hadn't registered the name with the U.S. Patent and Trademark Office before you first used it). But the chain could prevent you from expanding into other areas of the country if this ever became your goal.



CAUTION

New marketing techniques, new competitors. As mentioned at the beginning of this chapter, with our ever more digitally connected economy, the old rule that small, local businesses don't have to worry about trademarks from other geographical regions has largely gone out the window. Today, even small, local businesses commonly establish websites; hundreds of thousands of businesses send out catalogs; and some local restaurants and hotels seek to reach a national (or even worldwide) pool of tourists. The upshot is that many formerly local businesses that just a few years ago never would have been confused with each other are now competitors, which of course increases the likelihood of customer confusion and trademark infringement if their names are the same. (Be sure to read "Trademark Issues Online," below, to learn about trademark considerations in today's ever-shrinking world.)

Of course, there are plenty of gray areas in which two businesses aren't in head-to-head competition but use the same marks for products that are similar enough to make a customer stop and think. For example, "Is a Parker calendar made by the same company as Parker pens?" Even though a company with the same name might not be stealing business from a competitor, it could be unintentionally taking advantage of that company's goodwill and getting a free ride from its advertising.

Whether infringement exists in these gray areas often depends on the strength of the original trademark (as discussed above). If the original trademark is weak, there's probably not much goodwill or reputation to rip off (few customers would be confused by the similar name), so a court wouldn't be likely to find there was infringement. But if the original trademark is strong, there's a greater likelihood that the newer trademark will benefit from the older one's reputation, making it likely for the court to agree that there's been an infringement.

EXAMPLE: Your pet products company begins selling a chew toy that looks like a weasel, which you name the Garden Weasel. Soon after your toy hits the market, the makers of the nationally marketed Garden Weasel five-way garden tool contact you, claiming that you are infringing their trademark. Because you feel that the products are unrelated enough to minimize the chance of customer confusion (the products don't compete with one another), your first thought is to stick with the Garden Weasel name.

Think again. The Garden Weasel trademark is distinctive (memorable and unusual) and, therefore, strong. If you are sued—and you may well be—defending the lawsuit is likely to cost you tens or possibly even hundreds of thousands of dollars that you almost surely can't afford. And if the Garden Weasel mark is strong enough, you could lose the suit, even though the products don't compete. A better approach would probably be to tweak your name a bit, to something like the Chewy Weasel or the Garden Ferret, for instance.

Sight, Sound, and Meaning Test

Obviously, dual use of identical trademarks can cause customer confusion, as discussed above. But what about merely similar trademarks? If two marks look alike, sound alike, or have the same meaning, a court could decide that they conflict with each other, just as if they were identical. Small or superficial differences between two trademarks might not be enough to prevent customer confusion. The difference in spelling, for example, does not make the name "Ekzon" sufficiently different from "Exxon" to avoid trademark problems. And even though they're expressed in two different languages, the names "La Petite Fleur" and "The Little Flower" have the same meaning, which increases the likelihood that some customers could confuse the two.

EXAMPLE: You open an auto lubrication business and name it Jiffy Oil. A few weeks later, you receive a stern cease-and-desist letter from the attorneys of Jiffy Lube, a national chain of auto lubrication businesses. The letter informs you that the name "Jiffy Oil" infringes on their rights to the trademark "Jiffy Lube": Customer confusion is likely because the names are very similar, are

used to describe an almost identical service, and mean pretty much the same thing. They demand that you change your business's name or they will sue. You'd be wise to comply with their demand. Their "Jiffy Lube" trademark, though a descriptive term (for fast lubrication), has become a very strong mark over time—customers have come to recognize it as a specific brand of service. And because your shop is a direct competitor of Jiffy Lube, the chance of customer confusion is high.

The Dilution Exception

As mentioned above, there is a big exception to the rule that one trademark infringes another only where there is the likelihood of customer confusion: Even when customer confusion is improbable, courts will stop a business from using a trademark that's the same as or similar to someone else's if the use serves to diminish—or "dilute"—its distinctiveness. This legal protection kicks in only when a mark is so well known that even if you were to use it in a different context from the original trademark, lots of people would think of the original trademark. For example, a court might stop an athletic shoe manufacturer from using the trademark Exxon or a gas station from calling itself Nike. Even though customers would not be likely to confuse an oil company with a shoe maker, this sort of copying is a legal no-no, because allowing others to use the very famous trademark can chip away at its distinctiveness and slowly reduce its legal strength. The oil company Exxon would be wise, however, to act promptly to stop the dilution (with a demand letter and a lawsuit, if needed), because if it lets the situation slide, and particularly if it lets others use the name, its case would be weakened.

Trademark Issues Online

As in many other legal areas, the traditional principles of trademark law are scrambling to keep up with the fast clip of technological change. The internet has changed many of the rules regarding trademark issues, just as it has created some entirely new ones. This section outlines a number of internet-related concerns regarding trademarks and business names.

The Internet Has Changed the Rules

As described in the previous section, one of the touchstones of trademark infringement is whether the two trademarks in question are likely to cause customer confusion. In the pre-internet world, small, local businesses didn't have to worry too much about name conflicts as long as no one in their area had a similar name. But geographic distance is irrelevant online.

Particularly if you plan to put your business online, you'll have to consider not only the trademarks of businesses already on the internet, but also those of businesses located anywhere the internet reaches—which, of course, is just about everywhere. If you create a website for a small home-based business, your business is no longer local in character. You're essentially launching a national or worldwide business that can compete with businesses everywhere, whether or not those businesses are online.

For example, if you create a website for your antiques and collectibles business, Dalliance Designs, you could be competing with every antiques seller in the country. If one of these owns the trademark "Dalliance Designs," that trademark owner could force you to change your business name.

The more that the business could in theory serve non-local customers, the more potential there is for a trademark infringement claim. Although courts are still chewing over many trademark issues raised by online commerce, it is already clear that, in some circumstances at least, an online business with the same name as yours poses just as great a threat of a trademark lawsuit as does a bricks-and-steel business across the street.

EXAMPLE: Jarrod is a mechanic who opens a small machine shop in a rural area of California. He's lived in the area for 30 years, and knows every business for miles around. Nevertheless, as part of choosing a name for his business, Jarrod carefully checks the phone book and the county register for fictitious business names. He ultimately settles on his first choice, Checkers Tool and Die.

All goes smoothly for a few months, until a customer compliments Jarrod on his slick-looking website. This leaves Jarrod totally confused, since he doesn't have a website for his business. But in talking with his customer about this mysterious website, Jarrod realizes that a machine shop in Florida is also using the name "Checkers Tool and Die," and it sells a number of specialized parts via an online catalog. This doesn't particularly worry Jarrod until his customer (a lawyer, naturally) goes on to explain that if the distant business can prove it owns the trademark to "Checkers Tool and Die" and convince a court that it shares the same market as Jarrod, it might be able to force Jarrod to stop using the name.

Although at least one customer has been confused, Jarrod doesn't really expect the Florida outfit to go after him—after all, his business is small and local, provides primarily repair services (with parts as a sideline), and doesn't sell on the Web. Nevertheless, even the possibility of legal trouble worries him—especially because he'd like to open a retail machine parts shop next to his repair shop. After learning that the Florida outfit has been using the name Checkers Tool and Die

for years and seems to be putting lots of energy into expanding its website, Jarrod decides to be safe and spend the time and money necessary to change the name of his business to White Mountain Tool & Die before he expands.

Domain Name Conflicts and Cybersquatting

Besides making sure that your business name won't create trademark trouble, if you plan to create a website for your business, you'll also need to choose a domain name that's legally safe. A domain name (such as Nolo.com) functions as its internet "address" online. Later sections of this chapter discuss the process of choosing and registering a domain name; for now, the focus is on the trademark issues that can arise regarding domain names.

The first thing you should understand is that, generally speaking, your domain name will function as a trademark if you conduct business at your site—that is, if you offer products or services for sale. This is true whether or not you register it with the U.S. Patent and Trademark Office (PTO). As discussed in "Trademark Registration," below, registering your domain name with the PTO will strengthen your power to enforce your trademark rights to it, but using it for a commercial purpose is all that's technically necessary to establish your trademark rights. For instance, amazon.com is the domain name for the online mega-retailer—and the name amazon.com also serves as a trademark. This means that trademark law prohibits anyone else from using the name "amazon.com" for their business.

Keep in mind, however, that if your domain name is generic, such as software.com or books.com, it won't qualify for much trademark protection. This rule applies to generic business or product names such as a lawyer, building supplies, or pet food—the law will generally not allow you to establish any trademark rights to these generic terms. But as discussed earlier (in talking about weak trademarks), even generic domain names can grow stronger with use. Consider etrade.com, which has become almost synonymous with online stock trading. Originally, the name wouldn't have deserved much trademark protection since it wasn't distinctive at all—anyone can slap an "e" on the beginning of a word. Now, however, the mark has acquired "secondary meaning" and is entitled to trademark protection.

For most business owners, one way to make sure their customers will find them online is simply to tack ".com" onto their regular business names. However, while trademark law will allow two or more companies to use the same name as long as

it won't confuse customers, the technical limitations of the web won't allow for two identical domain names. In other words, Ford Trucks and the Ford Modeling Agency won't both be able to use "ford.com" as a domain name. Because each website must have its own unique address, you might be out of luck if someone is already using your business name plus ".com" as a domain name. As you can imagine, this is where things can get sticky.

Dealing With Domain Name Conflicts

If you're starting a brand-new business that you haven't named yet, choose a name that can also be used as a domain name. That way, you can register it as a domain name right away and sidestep the whole issue of what to do if your domain name is already taken. You'll need to decide for yourself how important it is to have a domain name that's the same as your business name. If it's really important, you might have to work hard to come up with a business name that's good for business, available as a domain name, and available as a trademark. If it's not that important, your naming process will be somewhat easier—but you could regret it down the road when your business name can't be registered as a domain name.

You might learn, before or after starting your business, that someone else is using your business name as a domain name. In that scenario, you would need to pick another domain name or buy the one you want from the existing owner.

EXAMPLE: Gene and Beth run a combination bookstore-café in New Orleans called BooksPlus. After about a year of planning, they decide to launch a website—but are disappointed to find out that the domain name "booksplus.com" is already taken. By doing a search on the web, and by going to the booksplus.com website, Gene and Beth discover that the owner of booksplus.com is a freelance editor in Chicago. Gene and Beth probably won't be able to force the editor in Chicago to give up the name, because the editor's site probably would not confuse customers into thinking it was associated with their bookstore.

On the other hand, you might be able to assert your trademark rights against someone using your trademark as a domain name if either of the following applies:

- the other person's use of the trademark is likely to cause customer confusion, or
- your trademark is distinctive and nationally known—even if the other party's use of it is not likely to cause customer confusion. (As discussed above, laws against trademark dilution protect famous marks from use by others, even if customer confusion is not likely.)

EXAMPLE: Assume that Gene and Beth's bookstore, BooksPlus, already had a well-established national mail-order catalog business and the name BooksPlus was familiar to a national audience. In this situation, they might be able to assert their trademark rights in court and force the Chicago editor to give up the "booksplus.com" domain name.

You will have to carefully weigh the pros and cons of attempting to force someone to give up a domain name based on a potential trademark infringement. On the one hand, the possibility of prevailing and getting the domain name you want could make this course worth it, depending on your business model. On the other hand, remember that lawsuits cost time and money; they can easily exceed $10,000 in legal and court fees (and can sometimes cost ten times that amount). If your case is marginal, you might be better off simply choosing a different domain name or even buying the name from the other party, who might prefer to sell rather than fight a losing battle.



CAUTION

Don't neglect your trademark rights. Your trademark rights can become weakened if you fail to defend your trademark when you know or should know that it's being infringed. For this reason, it's probably a good idea to go after a website or any other business or individual that infringes your trademark.

Dealing With Cybersquatters

You might find that the domain name you want has already been registered by someone who wants to sell it back to you at a profit. For instance, suppose you own a well-known car racing magazine called *Auto Racing Today*. When you are ready to launch a website, you discover that the domain name "autoracingtoday.com" is already registered by another business, which offers to sell the name back to you for $10,000. This practice, known as "cybersquatting," became a real problem in the late 1990s before businesses realized the importance of reserving domain names as early as possible.

A federal law known as the Anti-Cybersquatting Consumer Protection Act makes cybersquatting illegal and provides remedies for those injured, including getting the domain name back and possibly receiving money damages. To win a cybersquatting lawsuit, you'll have to sue the cybersquatter in federal court and prove all of the following:

- The domain name registrant (the cybersquatter) acted in bad faith by registering the name solely to make a profit by selling it back to you.
- Your mark was distinctive at the time the domain name was registered.
- The domain name is identical or confusingly similar to your trademark.
- You were the first to use the trademark in commerce.

An alternative to a lawsuit is to use a procedure set forth by ICANN (short for Internet Corporation for Assigned Names and Numbers), the international group now in charge of internet domain name policy. ICANN's process for resolving cybersquatting disputes is known as the Uniform Domain Name Dispute Resolution Policy (UDRP), and typically will cost far less and take less time than a lawsuit. In a federal lawsuit and in an ICANN proceeding, you'll have to prove that all of the following are true:

- The domain name is identical or confusingly similar to your trademark.
- The registrant has no legitimate interests in or rights to the domain name.
- The domain name was registered or is being used in bad faith.

Another advantage of the ICANN procedure is that it can be used in international domain name disputes, while a lawsuit based on the Anticybersquatting Act can be brought only against domain name registrants in the United States. For more information, visit ICANN's website at www.icann.org.

Name Searches

By now you get the picture that a dispute over business names can be thorny. To avoid potential trademark hassles later on, you need to do some early digging before you settle on a name for your business. The main way to accomplish this is to conduct a name search to learn whether another business is already using a name that's identical or similar to the one you want. The information in this section will help you figure out how to go about researching your chosen name, and how to analyze your search results to determine whether the name is available.



TIP

Searching domain name availability. To find out if a domain name is available, simply go to one of the many domain name registrars online, like Namecheap.com (for others, just Google "domain name registrar" and you'll find plenty). The registrars typically allow you to enter the name you want and will tell you whether it's available. Doing a name search for trademark purposes, on the other hand, requires consulting more sources, as described in this section.

The scope of your search will depend largely on the size and geographical scope of your business and your plans for its future. If you plan from the outset to sell a product nationally—say, through website sales—you'll obviously need to worry about trademarks across the country. If, on the other hand, you're starting a small home-based service business, don't plan to advertise, and are relatively certain you

won't expand geographically, a search of names in your county, and perhaps state, might be all you need—though it's always wise to search widely so that you at least know what's out there.

Keep in mind that the extent of your search encompasses not only how widely you search geographically, but also how deeply you search—in terms of looking not only for identical names, but also for those that are merely similar or have a slight resemblance to yours. Searching for the exact name (also called a "direct hit" search) is quick and cheap, but risks missing look- and soundalikes. A more in-depth search, such as one that looks for names with slight variations in spelling, is safer, but can get quite complicated and expensive.

Sources of Name Information

Domain name research can be difficult because there is no one place to look. In large part, this is because a business can—and millions do—establish a trademark simply by using it. Because millions of marks aren't registered with the government, in addition to checking federal and state trademark databases you'll want to check many other sources of information, such as business directories and phone books, for unregistered trademarks.

You should check some or preferably all of the following resources for name conflicts, depending on how extensive a search you need.

The Internet

It is probably best to start with the internet because this resource is huge, fast, and free. Just Google the name to quickly see whether someone else on the web is using it and how.

Another easy way to check trademarks online is to go to a domain name registrar and put in variations of the name you want to use. If another company has reserved a domain name that contains your trademark, chances are you won't be able to use it. If the domain name qualifies as a trademark—which essentially means that the other company is using it to sell a product or service online—then, as described earlier in this chapter, you won't be able to use it as a trademark if your use would be likely to confuse customers.

Online Directories

Online business directories can be great sources of business name information (and they can also give you good ideas for names). You can also call trade associations and chambers of commerce to ask if they can provide lists or directories of businesses in the area.

Don't overlook the phone book—the online version is at www.yellowpages.com—as a valuable source of local name information. If you find someone in your local area who's using the name you want and your businesses are similar, there's no reason to waste money further searching the federal trademark register or other databases. However, if your businesses are different enough, you might still be able to use the name.

Federal Trademark Database

All those starting a business, no matter how tiny and local, should search the federal trademark database to determine whether the name they want to use has already been registered by a similar business in the United States. The most important reason to do this is to avoid being sued for "willful infringement." If you use a trademark already registered at the federal level (even if yours is a tiny, local business), you can be sued for knowingly violating someone else's trademark—even if you didn't actually check the federal database and had no idea it was there. Searching the federal database can be complicated, and there are a few different ways to go about it—including hiring a trademark search firm to do the work for you. (See "Searching the Federal Trademark Database," below.)

State Databases

Many state corporation and LLC filing offices (usually the Secretary of State) maintain databases of registered names of corporations, limited partnerships, and LLCs. To find out whether a name appears in your state's corporate, LLC, or limited partnership database, contact your state corporate filing office or look on its website to determine its process for name searches. You might be able to search for names by phone, by mail, or online.

In addition, check your state's trademark registry. This registry is often part of the Secretary of State's department, though sometimes it has its own department. Find out the trademark office's rules for searching, or hire a trademark search firm to do the work for you.

County Fictitious Business Name Databases

Many counties maintain databases of fictitious business names (FBNs) that have been registered in that county. Even if you won't be using an FBN—because you'll use your own name or your corporate, limited partnership, or LLC name—it's a good idea to check the FBNs used by other businesses in your county or state. Depending on how widely you're planning to search, you might want to search nearby counties or every county in the state.

Keep in mind that the free or relatively cheap searches offered by state and county agencies usually check only for exact matches—and won't tell you whether a similar name is included in that database. If, for example, the county clerk's office tells you that "The Dog House" does not appear in its fictitious name database, you might be surprised later to find that "The Dawg Haus" has been in business for years. In short, you might have to do a more extensive search than the one provided by the state or county office.



CAUTION

County and state databases have limits. Just because a name doesn't appear in any county or state name databases, that doesn't mean another business doesn't already own that trademark. Use of the name, not registration, is what creates trademark ownership. Plenty of businesses own trademarks that they have never registered, so it's important to check for unregistered trademarks using the resources discussed above. Also, many businesses won't bother registering at the state level, but will register a federal trademark. If you plan to invest time and money in establishing your trademark, it's essential that you do a federal trademark search, too.

EXAMPLE: Tom and Jen, both veterinarians in California, search their county's fictitious business name database for the name "Critter Care," which they want to use for the animal hospital they're planning to open. They don't find anyone else using the name in their area, so they believe they can use it. But just to be safe, Jen decides to check the California state trademark directory for the name. She finds out that a California corporation has already obtained state trademark protection for the name "Critter Care." Because that corporation was doing business under its own name and not a fictitious one, it didn't have to register with any county fictitious name databases—so even if Tom and Jen had checked fictitious names statewide they wouldn't have found it. (Tom and Jen also would have found the name by checking the Secretary of State's corporate name database.)

Searching the Federal Trademark Database

As discussed above, to avoid a charge of willful infringement, it's a very good idea to check the federal trademark registry, maintained by the U.S. Patent and Trademark Office (PTO). Although tiny microbusinesses might get away without a federal search, most businesses should accept the fact that the internet and other communication technologies have simply created too many potential trademark conflicts, even for small businesses. They need to search the PTO's database of federally registered trademarks.

If possible, begin your search with the free trademark database on the PTO's website. The PTO's database consists of all federally registered marks and all marks for which registration is pending. To start, go to the Trademark section of the PTO's website at www.uspto.gov/trademarks and choose "Search trademarks." Then follow the instructions you see on the screen.

If using the internet isn't feasible for you, visit your local Patent and Trademark Resource Center (PTRC)—there's at least one in every state—and use its research materials. (The PTO maintains a list of PTRCs nationwide; you'll find the list at the PTO website, at www.uspto.gov.) If a PTRC isn't convenient, a large public library or special business and government library near you should carry the federal trademark register, which contains all federal trademarks and service marks arranged by categories of goods and services.

Another option is to hire a professional search firm to do the work for you. You can order a complete search of registered and unregistered marks through TradeMark Express, CompuMark, Corsearch, or one of the PTRCs that offer electronic search services for very reasonable fees.

If you decide to hire a search firm, the cheapest and easiest type of national search is a direct-hit search, which will reveal whether another business has registered an identical name with the PTO. You can often hire one of the companies mentioned above to do a direct-hit search for a few hundred dollars or less. But while direct-hit searches are quick and cheap, they usually won't turn up trademarks that are similar, but not identical, to the name you're considering. For example, if you want to name your softball training center "The Strike Zone," a direct-hit search may not turn up a trademark for "The Stryke Zone." And, as discussed above, any mark that looks like, sounds like, or means the same as your name could present a trademark conflict.

More extensive national searches take a lot more time and money but may be necessary if you plan for your business to reach a wide audience and want to eliminate any risk of infringing someone else's existing trademark. For an in-depth search, it might make the most sense to hire a search firm; expect a fee of several hundred dollars for a professional, comprehensive search. If you decide to hire search services, you're likely to save money if you do some quick, preliminary searches on the internet yourself—to rule out some of your choices.

Analyzing Your Search Results

If, after your search, you determine that the name you've chosen does not already belong to someone else (or that someone

else isn't using a similar name), you can go ahead and use it. Assuming you really are the first user of the name, you'll own the trademark, which will give you the right to stop others from using it in certain situations. But because registering a trademark conveys important additional rights and protections, you might want to register your name with the federal and state governments. See "Trademark Registration," below, to learn more.

But what if your search turns up an identical or similar name to the one you want to use? If the name is a famous trademark, it's probably time to pick a new name. Remember that if using your business name diminishes a famous trademark's distinctiveness or disparages its reputation for quality, the owner of the famous trademark may stop you from using your name even if its customers aren't likely to be confused between its products and yours.



TIP

Be sure to check domain names. If your internet business will be important to you, pick a name that can also be used as a domain name. You can check whether a domain name is available at any domain name registrar like Namecheap.com or others.

If the name has been registered for official trademark protection, especially at the federal level, that's a huge "No Trespassing" sign that should be taken seriously. Owners of federally registered trademarks have the right to use their trademarks anywhere in the country, and it is easy for them to sue and recover damages. If your search shows that the name is being used but isn't registered at the federal or state level, you might have a bit more leeway—but not much more. The user might have common law trademark rights in the name and they have domain rights if they've registered the domain. If they provide a very different product or service from the one you plan to sell, and in a different geographic market, you might be safe to also use the name.

For example, just because a tiny clothing store in Boston calls itself Nature's Calling doesn't mean that you, in Aspen, Colorado, can't use Nature's Calling for your septic tank business. But if you wanted to start a clothing store in your town called Nature's Calling, and one already exists in Boston, you should at the very least do more research before using it. If a federal trademark register search indicates that the Boston store has registered the mark "Nature's Calling," your subsequent use is a clear legal no-no.

But even if the name is not registered and the Boston store seems like a local outfit, it could have plans to expand its territory or—even more likely—to create a website. Neither of these actions would necessarily prohibit your use of the name on your original store, but they could prevent you from using it more widely. The bottom line is that even if you feel certain that your business is different enough from that of the trademark owner to allow you to use the name, you should proceed only with lots and lots of caution.



TIP

How would you feel? If you are uncertain as to whether your proposed trademark would infringe an existing trademark, use a variant of the Golden Rule: How would you feel if you owned the existing trademark and someone else started to use it? Ask a few friends the same question. If any of the answers is "Pissed off," consider choosing a different name, or at least invest in a consultation with an experienced trademark lawyer.



RESOURCE

Comprehensive information on trademark issues. For more help understanding the nuances of different types of trademarks, picking a bulletproof name, searching and registering trademarks, defending your trademark and dealing with infringers, and using trademarks in other aspects of your business, see *Trademark: Legal Care for Your Business & Product Name*, by Stephen Fishman (Nolo). And you'll find lots of free information on trademarks and business names in the Patent, Copyright & Trademark area of Nolo's website.

Choosing a Domain Name

Assuming that your business will create a website—usually recommended—you'll need to choose a domain name and register it. (See Chapter 14 for more on doing business online.)

A great domain name should be memorable, clever, and easily spelled. But keep in mind that names that are ordinary and descriptive won't qualify for much trademark protection. Many good domain names—for instance, coffee.com, drugs.com, and business.com—are not eligible for trademark protection because they are the names of whole categories of products or services. Besides, virtually every such generic domain name is almost certainly already registered by someone else. Likewise, domain names that use surnames or geographic names are unlikely to get trademark protection. (Of course, it's possible for a generic name, such as etrade, to become famous and develop "secondary meaning.")



TIP

You might want to register several domain names. In addition to your business name, you might want to register the names of your products or services, or other related names. Remember, names of your products or services can be as important as your business name, from a marketing perspective. It's also a good idea to register common misspellings of your primary domain name and names that reflect the nature of your products or services. For example, if you design and sell gourmet aprons, and your primary domain name is kitchenstuff.com, you might also want to register aprons.com so that customers who are looking for aprons and enter "aprons.com" into their browser will land at your site. It will, of course, cost more for multiple registrations, but the increased traffic might be worth it. Domain name registration and maintenance fees are pretty manageable. You can register and maintain a domain for less than $25 per year.

One potential problem in picking a domain name is that millions of names are already taken. For example, if your business name is Ace of Cakes, you may find that aceofcakes.com already belongs to someone else, so you'll have to use a different domain name or change your business name if it's important to you that your business name and domain name are the same.

If you do find a domain name that's available, make sure the domain name you pick doesn't conflict with someone else's trademark. Even if you come up with a domain name that is brilliant from a marketing standpoint, be aware that your domain name is at risk if it legally conflicts with any of the millions of commercial trademarks that already exist. (See Chapter 14 for detailed information on registering domain names.)

Trademark Registration

By now you understand that registering your trademark will strengthen your rights to it and make it easier to protect the name in case of a dispute. Registration is simply the process of notifying the state or, more commonly, the U.S. government that you're using a particular trademark.

When registration is complete, the trademark gets placed on an official list of registered names commonly called a trademark register. The PTO maintains two registers, the Principal Register and the Supplemental Register. State trademark offices have their own systems.

When people refer to a federally registered trademark, they're generally talking about marks on the Principal

Register. Trademarks that appear on the Principal Register get the most protection, and penalties can be harsh for those who improperly use a name that's on it. The Supplemental Register, on the other hand, is reserved for weaker, less distinctive trademarks that don't qualify for the Principal Register. The main function of the Supplemental Register is to provide notice of a mark's current use to anyone who does a trademark search.

The PTO encourages trademark registrants to use the online Trademark Electronic Application System (TEAS) to submit their applications. You can find access to TEAS (including excellent instructions for completing the application form), at www.uspto.gov/trademarks.

State registration processes are generally similar to the federal system's procedure. Contact your state's trademark office for more information.

State Versus Federal Trademark Registration

State registration doesn't give as many benefits as federal registration, so it generally makes the most sense to register federally for the widest scope of protection. Some trademarks, however, don't qualify for federal registration, because they aren't used in national, international, or territorial commerce—in other words, they're only used within the state. These marks can be registered only at the state level. Although use of a trademark on the internet almost guarantees the right to apply for federal registration, state registration might be the only option if you truly are using the mark only within your state.

Winning Names for Your Business, Products, and Services

Now that you have a general idea of the legal hurdles you need to clear and the snags and traps to watch out for, let the naming begin! Despite the trademark hassles involved, choosing names for your business and its products or services remains one of the fun parts of starting your business. It gives you a chance to use your creative juices to come up with a name that is both marketable and infused with your individual personality (or the collective personalities of all the business partners). A business name can help you establish the overall vibe of your business, from strictly professional to downright funky to a dozen things in between.

In addition to legal restrictions and personal preferences, the traditions and realities of your particular industry or business will probably have a lot to do with what kind of business name you choose.

Good, memorable business and product names range from the clever (Super Elastic Bubble Plastic, Garden Weasel, Liquid Paper) to the straightforward (24-Hour Fitness, Fruit Roll-Ups, Jenny Craig Weight Loss Centers) to sometimes even the cryptic (Chia Pet, Floam, Yahoo!).

In part because there really are so many different kinds of businesses and so many approaches to choosing a distinctive name, it's difficult to give any kind of specific advice on choosing a great name. However, it's helpful to keep a few things in mind when choosing business names:

- **Straightforward, informative names often work better than evocative ones, especially for small local businesses that don't plan to expand geographically.** For example, if you plan to open a shop selling aquarium supplies and tropical fish in Seattle, "Seattle Aquariums & Fish" might be a far more effective name than "The Lure of the Ocean." Also, because humble, descriptive names qualify for less trademark protection (unless they are already famous), choosing an ordinary name—especially one with a geographic identifier—will make you less likely to infringe on someone else's trademark.
- **Think about how your customers will locate your business and your products.** If you don't expect customers to seek out or remember your company as a whole, but only its products, it's silly to focus much attention on the business name (which you might never use as a trademark). For instance, while millions of people know the product The Clapper and its commercial jingle ("Clap on! Clap off! The Clapper!"), few know or care who its makers are.
- **Before you commit to a name, get some feedback from potential customers, suppliers, and others in your support network.** They might come up with a downside to a potential name or suggest an improvement you haven't considered. You obviously don't want to choose a name or symbol and learn later that it offends or turns off a key group of customers. For example, one organization we know couldn't figure out why it got such a cold shoulder from Mexican Americans. The answer turned out to be that the shape, size, and typeface used on its signs was similar to a "No Trespassers—Keep Out" sign widely used in Mexico. A quick Google search yields plenty of other examples—such as Kentucky Fried Chicken's "finger lickin' good" slogan, translated in China as "eat your fingers off."

- **Niche businesses are often identified by their trade names, even when the focus is on the products.** It's wise to pay attention to picking a memorable name if you will try to capture a particular, small field. The publisher of this book, Nolo, is a good example. Nolo customers have come to recognize its name, often going into a bookstore and asking where the Nolo books are. In other words, Nolo has come to mean "self-help law" to many customers familiar with it, in contrast to the name HarperCollins—a large publisher of books on many topics—which might not evoke anything particular in most book customers' minds.
- **In certain service businesses in which an owner's personal attention and savvy is important (for example, architecture or accounting), it is common to use the owner's name, as in Charles Schwab.** In other service and retail businesses, it is more common to use creative names—Kinko's and Fuddrucker's come to mind—not only for the business itself, but sometimes for its products, too.

  EXAMPLE: Jerri and Orlando operate a car wash named Storm, which develops a good deal of name recognition in the city. Besides relying on the reputation of their trade name, they come up with clever names for various service packages (such as Sunday Shower, Typhoon Tuesday, and the Everyday Squall Special) in hopes that those names will catch on as well.

- **Be sure your trade or business name will still be appropriate if and when your business grows.** For example, if you open Miami Surf Shop, will it be a problem (or an advantage) if you want to open a second store in Orlando? Especially if you plan to sell products on the internet, you should think carefully about giving your business a geographical identifier. Similarly, if you start a business selling and installing canvas awnings using the name Creative Canvas Awnings, your name might be a burden if you decide to also start making other products such as canvas signs. On the other hand, the name Creative Canvas would let you move into all sorts of canvas products, such as duffel bags, canvas signs, and drop cloths.



TIP

Think nationally even if you act locally. As discussed throughout this chapter, even though you might plan to open just one local office or store, it's a good idea to be sure your name is safe from trademark conflicts on a statewide or even national basis (and, if appropriate, from domain name conflicts). Then, if your business takes off, you won't bump into someone else who already uses the name online or in another area.

Chapter 2 Checklist: Picking a Winning Business Name

- ☐ Become familiar with the basics of trademark law, including what types of trademarks qualify for maximum legal protection.
- ☐ Draft lists of business, product, and domain names that could work.
- ☐ If you plan to do business online, check to see whether your proposed business names are available as domain names. (Ideally, your domain name(s) will be the same as your business or product name.)
- ☐ Do a trademark search of the names on your list.
- ☐ If any names are already being used as trademarks, eliminate the ones that either are already famous trademarks or would lead to customer confusion if you also used them.
- ☐ Choose among the names that are still on your list.
- ☐ Register your business and product names as domain names whenever possible.
- ☐ Register your business and product names as trademarks.

CHAPTER 3

Choosing a Business Location

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For many types of businesses, location can mean the difference between feast or famine. Other enterprises will do more or less the same whether they're located in downtown Manhattan or in a deep crevasse on Mars. Not only does the importance of location vary greatly from business to business, but what makes a location desirable for one business might not work for another. Because no universal definition determines what makes a location good for business, it's important for every business owner to figure out how location will (or will not) contribute to the success of the business—and to choose a spot accordingly.

That said, everyone needs to consider some basic issues when choosing a business location. For starters, make sure the location makes economic sense. You won't want to spend a fortune for a spot on an exclusive commercial strip unless it's really going to pay off. It's obviously important that the rent for your business space fits into your overall budget. But don't be too frugal in this area—even the best-run business will fail if its customers can't find it or don't want to go to an inconvenient or unsafe neighborhood. And, of course, the location that you choose needs to be legally acceptable for whatever you plan to do there.

Since 2020 there's another consideration: Remote and hybrid workplaces are becoming common. Employees and owners alike are working from home more often than they used to, even if not exclusively. Many workers appreciate the option to work from home either for COVID avoidance or to save commuting costs. But not everyone wants to work from home; many folks prefer working in-person with others. In short, COVID has upended many norms, expectations, and patterns of working locations and styles. You'll need to consider all these angles when figuring out what and where your workplace will be.

Especially if you are planning to work from home or in a nonbusiness area, you'll need to check zoning laws to see if they prohibit your type of business. This chapter will help you figure out how to find a suitable place that meets all the needs of your business and complies with local laws.



SKIP AHEAD

Planning to work from home?

If you've already decided that you want to run your business from home, you can skip most—but not all—of this chapter. Read "Complying With Zoning Laws" for a good introduction to zoning rules, and see "Zoning Rules for Home Businesses" for more detailed information. After you read this material, turn to Chapter 10 for a more in-depth treatment. That chapter is devoted to the special issues facing home business owners—including zoning, the home business tax deduction, and risk management.

Picking the Right Spot

Your first task is to figure out how important location is to your business. For some businesses, the classic "location, location, location" advice definitely applies. But for others, location might be a lot less important than getting affordable rental space. And location is practically irrelevant for plenty of businesses, such as wholesalers, service businesses that do all their work at the customer's location (like roofers or plumbers), mail-order companies, and internet-based businesses. Especially if you can pass on your rent savings to your customers, picking a spot in an out-of-the-way area might be to your advantage. In other words, if location isn't that crucial to your business, don't blow all your start-up money on an expensive space in a thriving location.

If, on the other hand, you determine that location will be important to your business success, you'll need to figure out the best place to locate so that lots of customers can find you. Ask yourself these questions:

- Will customers come on foot?
- Will customers drive, and, if so, where will they park?
- Will more customers come if I locate near other similar businesses?
- Will the reputation of the neighborhood or even of a particular building help draw customers?

As you ponder these and similar questions, here are a few things you'll want to consider.

Planting Yourself in Rich Soil

The key to picking a profitable location is figuring out the factors that will increase customer volume for your unique business, and then concentrating on finding a location that achieves as many of them as possible. For example, if you're opening a coffee shop, you can assume that your customer volume will be highest if there's lots of pedestrian traffic nearby during the hours you plan to be open. Furthermore, if you envision your café to be a mellow place to sit and read, you'd probably prefer a university area or shopping district full of people with time to kill, rather than an area buzzing with busy businesspeople. If, on the other hand, you plan to open a small coffee shop with no tables—just fast, high-volume service—a busy downtown office district might be the right spot.

Entrepreneur's Insight

Audrey Wackerley, former owner of Retro Fit, a vintage clothing store in San Francisco, California

When we first opened, we got a space in the perfect neighborhood, with lots of thrift stores, coffee shops, and other walk-in type businesses on a strip with lots of foot traffic (plus, it was only a few blocks from my apartment). But we were on a cross street a few doors around the corner from Valencia Street, the main strip. We did okay, but nothing like the shops on Valencia itself. Finally, we got a good deal on a storefront on Valencia Street, and we moved. Our business practically tripled! We paid a bit more for the better space, but our boost in sales more than made up for it.

Keep in mind that different types of businesses attract customers in different ways. One key distinction is foot traffic versus automobile traffic. An auto repair shop, for example, will obviously draw customers in radically different ways from the coffee shop. For the auto shop, the choicest locale is a well-traveled street, where it will be seen by many drivers who will easily be able to pull into the lot. For an urban coffee shop, on the other hand, a popular location might be in an area where there are lots of people passing on foot. Of course no rule is absolute—for example, some coffee shops thrive on busy thoroughfares because commuters stop for to-go coffee and baked goods every morning.

Also think about whether it would benefit your business to be around similar businesses that are already drawing the type of customers that you want. A women's clothing store, for example, would no doubt profit from being near other clothing shops, because people shopping for clothes tend to shop in "clusters" of stores.

The point is, the perfect location for any business is a very individual matter. Spend some time figuring out the habits of the customers you want to attract, then choose a location that fits.

Keeping Rent Within Your Budget

One obvious and important factor in finding a business space is how much you can afford. Chances are that you have found or will find a fabulous spot that you can only dream about because the monthly rent is so high. While it's okay to dream, don't be foolish enough to overpay for a space that you can't afford. As part of your business planning (discussed in detail in Chapter 4), determine how much rent you can afford each month, and stick to it.

One good way to find out how much rent is reasonable for an area is to call a commercial broker or agent in your area and have a chat about how much space generally goes for in the areas you're considering. Brokers and agents will usually give you an

average figure for what commercial space costs per square foot per year in a given area; once you have this figure, you can compare it to the costs of any potential spaces you're considering. But keep in mind that agents and brokers are self-interested professionals who might benefit from higher rents. In other words, don't uncritically accept the figures they give you.

Square footage rates are generally given in cost per year, so once you multiply the rate by the square footage of a space, you'll need to divide it by 12 to determine the monthly rent.

Entrepreneur's Insight

Pamela Slim, author, *The Widest Net* and *Body of Work* (www.pamelaslim.com)

When choosing a location for my downtown Mesa, Arizona, small business incubator, I looked for both great physical qualities in the space (nice light, ample room, good parking) as well as trusting my instincts about the feeling of the area. I visited a whole number of spaces that were beautiful and very functional. But it was not until I saw my space that I knew instinctively it was in the exact right spot. Not just because it was located between a cookie store and a toy store (that helped!), but because it was exactly in the center of town. I love being in the middle of the action on Main Street, and am so happy with my choice!

EXAMPLE: Jennifer and Oliver are planning to open a theater in a certain neighborhood of their city. They call a few real estate brokers out of the phone book whose ads indicate they handle commercial space leasing. All the brokers say that commercial space in the area they like usually goes for $10 per square foot. (Jennifer and Oliver know that this is an annual figure, which works out to about $0.83 per square foot per month.) A few weeks later, Jennifer and Oliver notice a building for rent, and they call the agent for more information. The agent tells them that the monthly rent is $1,800, and that the space is 2,400 square feet. Jennifer and Oliver do the math and see that the rent is slightly less than the going rate for the area:

	Monthly rent		$ 1,800	per mo.
×	12 months	=	$ 21,600	per year
÷	2,400 sq. ft.	=	$ 9	per year/sq. ft.

For comparison's sake, they do the math to determine what the rent would be if the space rented out for the going rate, $10 per square foot:

	Cost per sq. ft./mo.		$ 10	
×	2,400 sq. ft.	=	$ 24,000	per year
÷	12 months	=	$ 2,000	per mo.

They're not quite ready to enter into a lease, but the fact that this space is somewhat of a bargain puts it near the top of their list.

Though being realistic about your rent is important, don't sabotage your business by picking a cheap but bad location. This mistake might seem obvious, but sometimes new business owners become blind to common wisdom when presented

with an opportunity to rent a super-cheap space. Even if they've already determined that location will play a key role in their success, they either believe that the savings in rent will make up for slow sales or convince themselves that they'll be the pioneers in a new area that is sure to swell into a hot business district by the middle of next week. While this does occasionally happen (bless those brave pioneers), it's generally a poor idea to move into a dead section of town, because it almost certainly won't bloom fast enough to support your business in its financially vulnerable start-up days.

Unless you have a sound reason to believe that you'll get enough customers in your oddball location, don't let the lure of low rent tempt you into a bad business decision. At least in popular urban areas, rent can be the highest overhead expense for many new businesses.

Getting the Right Physical Features

When picking your space, your biggest consideration might not be where it is but what it is. Ask yourself whether the building facilities are appropriate or adaptable for your business. For example, if you're planning to open a coffeehouse, you might fall in love with a beautiful brick warehouse space in a funky shopping district. But if the place doesn't have at least minimal kitchen facilities, you should probably forget it. Unless you can convince your landlord to put in the needed equipment—plumbing, electrical work, and the rest (discussed below)—it's highly unlikely that laying out the cash to do it yourself will be worth it.

Sure, some improvements might be relatively cheap, such as putting up a wall or two or adding new light fixtures. But if the building lacks something major that is essential to your business operation, take it as a sign that the place isn't right for you—even if it has loads of other great qualities. You'll have to decide for yourself which features your business absolutely can't live with or without.

EXAMPLE: Charlotte and Sandra plan to open an alternative health store that will offer products such as medicinal herbs, aromatherapy products, and yoga supplies. They also plan to offer services such as aromatherapy sessions and consultations with nutritionists and herbalists. Charlotte and Sandra have high hopes for the service side of their business, so their physical space needs to be comfortable and appealing to customers. After looking at a number of storefront spaces in their chosen neighborhood, they find one that seems just perfect—except for the lack of windows. Except for the glass front door, the place has almost no natural light. Even though not having windows doesn't absolutely prevent them from doing business, Charlotte and Sandra decide that, given their expected customer base and their own feelings, they need a brighter space.

For most businesses these days, it's important to have modern phone lines and broadband internet access. Anything less than a reliable high-bandwidth internet connection can seriously impact your productivity (and drive you crazy to boot). Some buildings may have outdated phone lines that can result in dropped telephone connections—not exactly a good thing for business. When you're considering a specific space, ask the agent or the landlord for any information on the phone and data lines into the space.

In addition to dealing with concerns about high-tech communications wiring, don't overlook plain old electrical power as an important consideration in choosing a business space. Make sure that any space you're looking at has enough power for your needs, in terms of both the number of outlets and the capacity of the circuits. If you'll mostly be running computer equipment, a copier, a coffee machine, and the like, chances are that any reasonably equipped commercial space will have enough power for you. But if you'll be running machinery or other electricity-hungry equipment, make sure to find out from the landlord how much juice the circuits can handle and whether a generator is available during power outages. Also, if you'll keep sensitive computer equipment at your office, ask the landlord how many hours of air-conditioning are included in the terms of your lease, and negotiate longer hours if necessary.

Another common need for many businesses is adequate parking. If a significant percentage of your customers will come by car and there isn't enough parking at your chosen spot, it's probably best to look elsewhere. In fact, the city might not allow you to operate there if parking isn't adequate.



TIP

Check local planning and health department requirements. If you're starting a small food manufacturing business to produce energy bars, you might need to rent a space with a certain number of vents, a fire-resistant roof, and walls of proper material and adequate thickness. You might also need a safe place to park refrigerated delivery trucks. And your business could be subject to special waste disposal requirements, so you might need extra space for waste storage or equipment. Contact your city or county departments of planning, health, or fire, or another appropriate agency to find out. You should also check out state and federal laws that apply to your business. (See Chapter 7 for a discussion of licenses and permits.)

Complying With Zoning Laws

A certain spot might be good for your business, but if it's not properly zoned for what you plan to do, forget it. Local zoning laws (often called "ordinances" or "land use regulations") prohibit certain activities from being conducted in particular areas. To use an obvious example, a nightclub wouldn't be allowed to operate in a district zoned for residential use. Sure, only a fool would try to open a disco on a quiet residential street—but there are less obvious zoning restrictions that you must observe.

Zoning ordinances typically allow certain categories of businesses to occupy particular districts of a city or county. For example, mixed commercial and residential uses might be allowed in one district while another district allows heavy industry and warehouses. So if you open your small jewelry-making business in a space zoned for commercial use, you could be in for a real headache if zoning officials decide you're a light-industrial business that's not allowed to operate in a commercial district. Similarly, you might not be allowed to run a commercial business—particularly one that's open to the public—in an industrial zone.

In addition to regulating the types of businesses allowed in certain areas, zoning laws also regulate specific activities. Depending on your area, you might be subject to laws regulating parking, signs, water and air quality, waste management, noise, and the visual appearance of the business (especially in historic districts). In addition to these regulations, some cities restrict the number of a particular type of business in a certain area, such as allowing only three bookstores or one pet shop in a certain neighborhood. Finally, some zoning laws regulate home businesses.

Expect Zoning Laws on Parking Spaces and Business Signs

Local zoning laws commonly require a business to provide parking, and they also may regulate the size and type of business signs. Be prepared for your city or county to look into both these issues. If there's already a parking problem in your proposed area, you might have to come up with a plan for how to deal with the increased traffic your business will attract.

Be ready for zoning officials to get really nitpicky about your business sign. Many local laws limit the size of business signs (no signs over five feet by three feet, for instance), their appearance (such as whether they're illuminated, flashing, colorful, or made of neon), and their placement (flat against the building, hanging over the sidewalk, or mounted on a pole). Some regulations even attempt to limit the use of foreign language on signs. Be sure to find out what your local regulations are before spending money on having signs made.



TIP

Know your neighbors. More often than not, zoning laws are enforced for the sake of the other people and companies in the neighborhood (this is particularly true of home-based businesses). While some areas are strict about their zoning laws, most of the time you won't have a zoning official knocking unannounced on your door unless neighbors have complained or you're in flagrant violation of the laws. Because enforcement is often triggered by complaints, it's a good idea to get to know your neighbors and develop good relationships with them. If you plan to run your business from home, be sure to read Chapter 10, which covers special zoning issues for home businesses.

Never sign a lease for a business space without first knowing that you'll legally be able to do business there. However, it's okay to sign a contingent lease, with a clause stating that the lease won't be binding if you don't get zoning approval. Being forced to move your business is a headache enough, but not nearly as catastrophic as having to pay rent on a lease for a space that you can't use.

When determining whether you'll be able to do business at a potential location, never assume that you'll be allowed to do a certain activity simply because the previous tenants of the space did it. For all kinds of reasons, some businesses get away with zoning violations, even for long periods of time. But new occupants are sometimes scrutinized more carefully than already existing businesses. It might not be fair, but a new business may be told it can't do what an old one had long been doing.

It's also possible that the previous tenants had an official okay to operate outside the zoning restrictions. For example, the previous occupants might have had a zoning variance (an exception to zoning laws) for their particular business—one that won't necessarily be extended to you. And lots of times when zoning laws change, businesses that are already in place are allowed to keep doing what they were doing, even if the activity violates the new zoning law (sometimes described as "legacy" exceptions). When a tenant with a legacy exception leaves and new occupants come in, however, the new business usually has to abide by the new, more restrictive zoning law.

Finding Out Which Laws Apply

How do you find out whether a location is properly zoned for your business and whether you need to get approvals? The answer varies from area to area. In some cities and counties, zoning approval is part of the tax registration process (discussed in Chapter 7). In San Diego, for instance, when you apply for your business tax certificate, you must also self-certify that your business activities are allowed at the location listed on your application. The city of Albuquerque also requires businesses to get zoning approval before allowing them to obtain a tax registration certificate. Other cities don't require

proof of zoning approval before issuing a tax registration certificate—but that doesn't mean you should take the zoning laws any less seriously. Even if you're not required to deal with your local zoning department before starting your business, you'll still be subject to its monitoring and enforcement.

If your city doesn't include zoning approval as part of its start-up requirements for new businesses, you'll need to do some detective work. Start by talking with your local zoning officials.

Most zoning agencies are part of city or county planning departments; check your city or county website. If your business will be located in a city, you probably need to worry only about city zoning ordinances. Businesses in rural areas should contact the county zoning or planning offices.

Getting zoning approval typically begins with filling out a form issued by the city planning department, where you provide information about your proposed location and what you plan to do there. In some cities, you may be required to submit detailed building plans to show exactly how you intend to use the space in question. Your application may be evaluated simply on the information you provide in the form, or the zoning department may send out an inspector to more closely examine the potential business space. Once the zoning department has all the information it requires to make a decision, it will either approve your application without limitations, approve it with certain conditions, or deny it altogether.

How Vigilant Are Zoning Officials?

There's a world of difference from area to area in how strict zoning officials are. Many zoning departments aren't terribly rigid about enforcement, mostly responding to complaints from neighbors or other citizens about businesses that create a nuisance or other trouble. In a few areas, however, zoning agents relish sniffing out minor infractions and enforcing their zoning ordinances to the letter.

If you're considering going ahead with your business despite what you consider to be a minor zoning problem, you should do your best to find out how strict the zoning police are in your area. Start by asking other local businesspeople about their experiences. If they tell you that there's little enforcement other than responding to complaints, you can breathe a little easier about what might be a minor infraction, such as including tennis racket stringing (which officials might consider a light-industrial activity) at your sports shop in an area zoned only for commercial use. Even so, it never pays to engage in a prohibited activity that is fundamental to your business. While tennis rackets could be strung elsewhere, a health club wouldn't want to have to locate its juice bar two blocks away.

But no matter how mellow your zoning department, at the very least you need to know what the rules are for your proposed location. Ignoring the rules while counting on lax enforcement is just plain dumb.

Dealing With Zoning Snags

If your zoning board has a problem with any of the activities you plan to conduct at your chosen location, you have a few options, usually ranging from making appropriate changes to your business to giving up on that location and finding a new one. Obviously, some zoning conflicts are simply not fixable—for example, you'll never be allowed to open a manufacturing facility on a quiet residential cul-de-sac. But a creative (and, when necessary, assertive) business owner can often persuade zoning officials or the zoning appeals board to work out an acceptable accommodation that will allow the business to use the desired location.

For borderline situations, one approach is simply to advocate an interpretation of the zoning law that's favorable to you before you get an official "No." Communicate with zoning officials, and try to persuade them to give you their seal of approval.

If the zoning officials have already denied your application, it's often possible to appeal their decision, usually to a higher authority such as a board of appeals within the zoning agency or the city council. If you're successful, the zoning board may grant you a "variance," which is basically a one-time exception to the local zoning laws. Or the board may give you a "conditional use permit," which essentially gives you approval to operate your business as long as certain conditions are met, such as restricting the maximum occupancy to a certain number or providing additional parking spaces.

When lobbying for an exemption from a zoning requirement, be aware that you're asking for special treatment, so make your case as persuasive as possible. If your business will be valuable to the community, present evidence of that fact. Proof can include demographic data about the area, testimony from community leaders, or statements from other local businesspeople. Your goal is to show that the value of allowing your business in the area is greater than the trivial zoning conflicts that might exist. If you can compromise in some other area, offer to do so.

EXAMPLE: Carolyn wants to open a small printing shop, Nelson's Press, on a commercial strip where storefront space is cheap and plentiful. Before signing a lease, she applies for zoning approval. The local zoning board rejects her application because Carolyn's proposed location is zoned commercial, but her print shop would technically be a light-industrial business. Carolyn decides to try to get an exception, because her printing operation will be small (only one small offset printing press) and would be an asset to the neighborhood, which has been struggling economically.

She submits detailed plans of her business to the zoning board, showing the business's small scope and including specific protocols for dealing with toxics such as ink. She also submits letters from other business owners in the neighborhood

documenting how commerce in the area has languished for years and arguing that new businesses would help revitalize the strip. Many of the business owners also note that a local printer would be convenient for the existing area businesses, which currently have to go across town for their print jobs. A few weeks later, Carolyn gets a conditional use permit allowing her to proceed with her printing business, as long as she doesn't expand her business with additional presses and follows a number of standard rules governing the chemicals she'll use in printing.

Zoning Rules for Home Businesses

Similar to business owners who operate from commercial office spaces, those who run home businesses need to make sure they don't violate their local zoning rules. As home businesses exploded in popularity starting in the 1990s, more local governments have adopted specific provisions in zoning laws controlling them. And in the age of COVID, even more self-employed people are working from home instead of office spaces. Mercifully, most of the rules governing home-based businesses are straightforward and fair—with some exceptions. If you're unlucky and find that you're subject to prohibitive municipal ordinances or private land use restrictions, take a hard look at whether you should set up shop in your home after all. But more often, you'll find that you'll need to jump through a simple hoop or two and pay a modest fee to run your business from home.

Dwellings in residential or mixed-use zones are often allowed to run businesses that have little likelihood of causing noise or pollution, creating traffic, or otherwise disturbing the neighbors. Examples include freelance writers, artists, attorneys, accountants, architects, insurance brokers, and piano teachers.

To find out local rules, contact your city's planning or zoning department and ask for information on its rules for home businesses. Often, home businesses are allowed with some restrictions—such as limiting employees to residents, curbing the number of customers allowed, and prohibiting business signs posted outside. Also ask the local zoning authority whether any special rules exist for your type of business or activities.

As to whether you need a permit to run a home business, local rules vary. If you'll need a permit, getting one is usually a simple matter of filling out a form provided by the planning department and paying a fee. You might also need to deal with other departments besides the zoning office. For example, depending on your business activities, you might need to get approvals from your county health or fire department.



CAUTION

Even if your home business passes zoning muster, make sure your lease doesn't prohibit your planned activities. If you rent a home or apartment and your lease is silent on the issue, you're not necessarily in the clear. If your activities disturb your neighbors— say, you teach drum lessons or have a constant stream of clients who take up precious parking spaces—you could be forced to stop or face eviction. We discuss running a business from home in Chapter 10.



RELATED TOPIC

For more on home office zoning. For more detail on permits for specific business activities, see Chapter 7 on start-up requirements. And see Chapter 10 for a full discussion of special issues facing home business owners—including zoning, the home business tax deduction, and risk management.

Commercial Leases

Chances are that you'll rent rather than buy a space for your business. After all, most small start-ups don't have the funds to purchase real estate, and it's usually not a good idea to saddle your business with high interest payments, anyway. But just because you've rented plenty of apartments or flats over the years, don't assume that you know the score when it comes to leasing business space.

Practically and legally speaking, commercial leases and residential leases have significant differences. Commercial leases are not subject to most consumer protection laws that govern residential leases—for example, there are no caps on deposits or rules protecting a tenant's privacy. Also, commercial leases are generally subject to much more negotiation between the business and the landlord, because businesses often need special features in their spaces, and landlords are often eager for tenants and willing to extend special offers. While a residential tenant will usually just take an apartment or flat more or less as is, a business owner will often need to modify the existing space—for example, by adding cubicles, raising a loading dock, or rewiring for telephones, internet access, and computers.

Because company owners must negotiate modifications suitable for their own operations, commercial leases are relatively flexible creatures. Of course, your bargaining power will vary a great deal from situation to situation. For example, getting a landlord to accept your demands would probably be a lot easier for a five-year lease in a largely vacant office building than for a six-month lease in a hot commercial area. Likewise, local independent landlords are often more willing to make concessions than huge property management companies or real estate investment trusts.

When negotiating a commercial lease, keep in mind that the success or failure of your business might ride on certain terms of the lease. The amount of the rent is an obvious concern, as is the length of the lease. (You probably don't want to tie yourself to a five- or ten-year lease if you can help it, in case your business grows faster or more slowly than you expect or the location doesn't work out for you.) But other, less conspicuous items spelled out in the lease could be just as crucial to your business's success. For instance, if you expect your shoe repair business to depend largely on walk-in customers, be sure that your lease establishes your right to put up a sign that's visible from the street. Or, if you are counting on being the only sandwich shop inside a new commercial complex, make sure your lease prevents the landlord from leasing space to a competitor. If you are starting a new service company that you expect to grow quickly, make sure there's room for expansion.

The following checklist includes many items that are often addressed in commercial leases. Pay attention to terms regarding:

- rent, including allowable increases and method of computation
- whether the rent includes insurance, property taxes, and maintenance costs (called a gross lease), or whether you will be charged for these items separately (called a net lease; in a "triple net" lease, the tenant is responsible for property taxes, insurance, and maintenance)
- whether the rent includes utilities such as heat, air-conditioning, internet, phone, garbage collection, water, and others
- the security deposit and conditions for its return
- who is responsible for code compliance (pay special attention to the Americans with Disabilities Act (ADA) access requirements, if your business is open to the public), security, and fire safety
- the length of the lease (also called the lease term) and when it begins
- whether there's an option to renew the lease or expand the space
- how the lease may be terminated, including notice requirements, and whether you'll have to pay extra for early termination
- exactly what space is being rented, including common areas such as hallways, restrooms, and elevators, and how the space is measured (some measurement practices include the thickness of the walls)
- specifications for signs, including where they may be placed
- whether there will be improvements, modifications (called buildouts when new space is being finished to your specifications), or fixtures added to the space; who will pay for them; and who will own them after the lease ends (generally, the landlord)

- who will maintain the premises and provide janitorial services
- whether the lease may be assigned or subleased to another party, and
- whether disputes must first be mediated or arbitrated before taking the case to court.



RESOURCE

For more on leasing office spaces. For detailed information on finding a space and negotiating a lease, see *Leases & Rental Agreements*, by Ann O'Connell and Janet Portman (Nolo).



CAUTION

Beware the Americans with Disabilities Act. The Americans with Disabilities Act (ADA) requires all businesses that are open to the public or that employ more than 15 people to have premises that are accessible to people with disabilities. Make sure that you and your landlord are in agreement about who will pay for any needed modifications, such as adding a ramp or widening doorways to accommodate wheelchairs.

Chapter 3 Checklist: Choosing a Business Location

- ☐ Determine how much rent you can afford.
- ☐ Decide what neighborhood best suits your business.
- ☐ Find out what the average rents are in the neighborhoods you're considering for your business.
- ☐ Identify the features and fixtures your business space will need.
- ☐ Make sure spaces that you're considering are or can be properly zoned for your business.
- ☐ Examine all commercial leases carefully —and negotiate the best deal you can.
- ☐ If working from home, make sure your business activities will not violate any zoning restrictions on home offices.

CHAPTER

4

Drafting an Effective Business Plan

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If you're determined to turn your business idea into a successful business, you'll need a business plan. Without a plan—and even more important, the activity of planning that is required in order to create a plan—you're leaving far too many things to chance. Just as a blueprint will ensure that a building will be structurally sound, a business plan will help you make sure that your business will reach profitability and sustain itself.

The purpose of a business plan is simple: to bring together in one document the key elements of your business. These include the products or services you'll sell, what they'll cost to produce, and the sales revenue you expect during your first months and years of operation. Most important, your plan will help you see how all the disparate elements of your business relate to one another, which will allow you to make any necessary alterations in order to maximize your business's potential to turn a profit.

Business plans are often written by business owners who want to borrow money or attract investment. Lenders and investors want to understand as much as possible about how a business will work before deciding whether to back it financially.

Unless you're prepared to show them a well-thought-out plan for making your business profitable, you won't have much chance of convincing them to finance your project.

But creating a business plan is a good idea even if you don't need to raise start-up money. The process of creating one often brings up issues and potential problems that you hadn't thought of before. And the important work of developing financial projections, such as a break-even analysis and a profit and loss forecast, will help reveal whether your business is really worth starting, or whether you need to rethink some of your assumptions. Experienced entrepreneurs know the value of opting *not* to start a business if its financial projections don't pencil out. Failing to do the planning work that will allow you to predict this outcome is a foolish gamble, one you're likely to lose.

This chapter explains how to create a thorough business plan. It simply and straightforwardly outlines a number of descriptive sections and financial reports that will help guide you in running your business—and that will help attract funding if you need it.



SKIP AHEAD

For those who already have a plan. If you've already written a business plan, you might want to skip ahead to Chapter 5, "Raising Start-Up Money." However, you might also want to review this chapter to evaluate the work you've already done.

AI-Driven Business Plan Generators

Online business plan apps and templates have been available for some time. Recent years have seen the emergence of business plan generators driven by artificial intelligence (AI), such as LivePlan (www.liveplan.com) and BizPlan (www.bizplan.com).

Based on your input, these AI-driven tools can produce a complete business plan for your business. They do the financial calculations to produce financial projections, including graphs and analyses, saving you from having to create your own spreadsheets in Excel or another program.

Online business plan generators also help with the narrative sections of your plan, by analyzing and improving upon your wording. They can also generate text, such as an executive summary, based on the content of your plan.

You can access these tools with monthly subscriptions, or in some cases via a one-time fee for lifetime access. If you need a professional-looking business plan to share with lenders or others, or if you want to streamline the process of writing a business plan, take a look at LivePlan, BizPlan, and other AI-driven business planning tools.

The U.S. Small Business Administration (SBA) website (www.sba.gov) includes several resources to help you write a business plan, including a step-by-step online Business Plan Tool.

Different Purposes Require Different Plans

All good business plans have two basic goals: to describe the fundamentals of the business idea, and to provide financial calculations to show that it will make money. But, depending on how you intend to use it, a business plan can take different forms:

- **If you will use your plan to borrow money or interest investors,** write it with an eye toward selling your vision to skeptical people. Generally, you should include a persuasive introduction and a request for funds, in-depth market research information, an evaluation of your main competitors, your key marketing strategies, and a management plan. In addition, your plan should contain detailed financial information—including your best estimates of start-up costs, revenues, and expenses. Finally, since your plan will be submitted to people who don't know you well, the writing should be polished and the format clean and professional. (See Chapter 5 for a discussion of business financing basics.)
- **If your plan will primarily be for your own use**—that is, if you don't need to raise money—don't worry so much about making a sales pitch or slick presentation. You should do at least a quick market and competitive

analysis to make sure you're on the right track with your idea. And don't skimp when it comes to doing your numbers. You'll need to include estimates of start-up costs, revenues, and expenses. The last thing you want is to experience the very real misery of realizing too late that your business never had a chance to make a profit.



TIP

Plan to get the help you need.

Not all businesspeople are great writers. But excellent writing skills can be a big help in creating a compelling business plan. Consider paying a freelance writer with business savvy to help you polish your plan. Similarly, if you are challenged by numbers, find a bookkeeper or an accountant to help with the math.

Describing Your Business and Yourself

The first several sections of your plan should describe the core value and strategy of your business idea. Establish right up front that you've hit on a product or service that customers really want. In addition, these sections should make it clear that you are exactly the right person to make this fine idea a roaring success. Your goal is to have readers say, "Wow! What a great business idea! And yes, I see exactly why Carlos Burns is the ideal person to make it happen."

Including the following sections will help you accomplish these goals:

- an executive summary of the entire plan
- a statement of the purpose and value of your product or service
- a detailed description of your business operations
- an analysis of your target customers
- an assessment of your competition
- a description of your marketing strategy, and
- a résumé setting out your business accomplishments.

Again, depending on how you intend to use your business plan, you could go light on some of these elements. For example, if you don't need to raise start-up money and are writing a plan mostly for your own use, you may decide to skip the résumé of your own business accomplishments. But think twice before you leave out too much. Any new business will need to be introduced to loads of people—suppliers, contractors, employees, and key customers, to name a few—and showing them part or all of your business plan can be a great way to do it.

Executive Summary

Most business plans start with an overview of the business plan as a whole, written as compellingly as possible to hook the reader into wanting to know more. It's best to write this section last, after completing the rest of the plan, and use it to highlight the plan's strongest selling points.

Think of the executive summary as the "elevator pitch" of your business plan: a concise description of the overall concept and any winning details that would intrigue someone you're talking to in the time it takes for an elevator ride.

Business Purpose and Value

The first section of your plan should address these questions as directly and compellingly as possible: What will your product or service be, and what needs will it meet? Why will customers want it more than they want similar offerings from your competitors? And crucially, what value does it offer to its intended customers? This section is sometimes referred to as your "value proposition."

It can be helpful to think about a slogan as you write this section, but you'll want to go deeper than just a one-liner. Spend at least a few sentences or paragraphs describing the value your product or service offers to customers. The best business concept or value proposition statements address the following elements: customers, needs/problems, and solutions. When you describe how your product or service will meet the needs of its target customers, and how it will do so better than competitors, you've described your value.

For example, a clothing business producing body-positive swimwear for large sizes could focus on how the swimwear will make customers feel comfortable, beautiful, and confident with its designs and materials, specifically tailored for larger women. It would describe the customers' need for attractive swim garments that function well during water sports. It would go on to detail how the company would solve this need with functional and fashionable designs, as well as smart choices of quality fabrics and quality construction, unlike other, flimsy "fast fashion" brands. Its slogan might be something like "Fabulous, functional swimwear for real bodies."

A business focused on an innovative hemp insulation material could use this section to describe the insulation properties the product offers, its durability and customizability, and importantly, its recyclability. This section would make it clear that the product offers an effective alternative for eco-conscious consumers to traditional insulation products whose production and disposal negatively affect the environment.

A description of the value of your product or service doesn't need to be complicated or lengthy. The essential elements to include are the customers, the need, and the solution.

Business Activities and Operations

Once you've stated the need that your business will fill, describe exactly how you'll go about filling it. Where the previous section focused on the business concept, this section will focus on execution. While

the degree of detail can vary depending on what kind of business you're starting and who will be reading your business plan, your description should include:

- what your income streams will be, with operational details for how you will provide the product(s) or service(s)
- details about the digital strategy of your business, clarifying to what degree your business will operate online versus a brick-and-mortar operation (more on digital strategy below and in Chapter 14)
- how customers will pay you, with attention to clarifying online vs. offline sales processes
- details about your supply chain, including your sources for key materials and a backup plan if those sources become unreliable
- how you will manage inventory and fulfillment
- how you will systematize service-based businesses
- your systems to manage customer service
- any important partnerships, such as distributor relationships or marketing networks
- if intellectual property (IP) plays a key role in the business, details about that IP
- how many employees and contractors you will have, and what their roles will be
- the key managers and their roles
- whether you and staff will work remotely or on-site, or a combo
- business location(s) and hours, and
- the company's ownership structure.



CAUTION

Be sure to include the costs of creating a website and doing business online. When budgeting for online business activities, include not only the costs to develop a website, but also the ongoing costs of maintaining and promoting it. Put careful thought into your digital strategy and online operations early on in your business planning efforts, to make sure they don't become an unexpected drain on your business later on. See Chapter 14 for advice on developing an online presence, including selling and marketing online.

Even the smallest, simplest business involves a swarm of pesky details. While you're writing your business description, don't assume there's anything obvious about your business, even if it's a tiny one-person operation. For example, if you plan to start a mobile pet-grooming business, how many types of services will you offer: Shampooing? Flea bathing? Nail cutting? Hair trimming? Teeth cleaning?

Will you charge separately for each individual service, sell them in packages, or both? How will you attract customers and regularly stay in touch with the best ones? How will you accommodate animals with special needs, such as allergies or behavioral

problems such as aggressiveness? How will you handle parking in dense urban areas? What will you do if an animal is injured or dies while in your care?



TIP

A little repetition is okay. The description of how your business will operate is likely to be the longest section of your plan and will probably discuss topics that are also covered elsewhere. No problem. For example, you should discuss the issue of how you will establish and keep a competitive edge in your big-picture business description as well as in the marketing strategy section. (See "Marketing and Branding Strategy," later in this chapter.)

Use the process of writing your business description as an opportunity to change or refine your business idea. When you write and rewrite this section, you'll probably come up with ideas and questions you haven't yet thought through. If so, great—this gives you an opportunity to fill in the gaps before you actually open for business. And even if you discover a flaw so big that you decide not to start the business after all, your business plan has done its job. While undoubtedly disappointing, it's far better for your business to fail on paper than in real life.

Target Customers

Who will buy your product or service? Even the most innovative business will fail if it doesn't quickly find enough customers to make a profit. In this section, your task is to demonstrate to a potential investor or lender (or convince yourself) that there are indeed customers out there, ready and willing to buy your product or service. Describe your anticipated customer base, and show that there is a demand for your product or service by referring to news reports, trade journal articles, or other reports. Use whatever data you can get your hands on. And don't neglect your imagination—unconventional arguments are fine, as long as they are convincing. Here is a brief list of points you might wish to make:

- **Similar businesses have been successful.** For example, if fitness clubs with meditation rooms and mindfulness coaches are all the rage in Los Angeles, you might explain why this is a good indication that your similar business would succeed in Chicago, where the market is currently dominated by more old-school gyms.
- **Marketing surveys or demographic reports point to a growing need for your product or service.** For instance, to buttress your contention that there will be a need for your new line of paralegal training materials, point to U.S. government reports listing paralegal as one of the fastest-growing occupations.
- **Media reports confirm the popularity of and demand for your business.** For example, include newspaper articles or

transcripts of television news reports on the surge of demand for antiviral air fresheners as evidence that your germ-killing Sani-Scent™ will sell.

Your conversations with potential customers show a need for your business. It's often a good idea to carry out an informal survey of your most likely customers and include the results. For example, if your business will be repairing and reconditioning acoustic guitars and similar stringed instruments, you might include results of a survey of guitarists and other musicians on what kind of repair services they need, as well as quotes from them saying that they'd use your services.

In addition to establishing that there is a solid demand for your business, do your best to define and describe exactly who your customers will be. If you're opening a bar with live entertainment, for instance, you might identify your market as primarily childless, urban 21- to 35-year-olds, who tend to have more disposable income and leisure time than others. Similarly, if you're planning an antique restoration service, you might identify your target market as professionals and others in the 40- to 70-year-old age range with household incomes of $150,000 or more. The better you can show that you know exactly who your target customer is, the more confident lenders and investors will be that you can actually find these people and sell to them.



TIP

Include a profile of your target customer. Explain why and how a fictional person would need and use your product or service. Try to flesh out a believable person. Creating a typical customer gives a face to an otherwise abstract market definition and gives your market analysis more impact. For more information on defining your target customer, see Chapter 13.

Competitive Analysis

Just because you have a great business idea doesn't mean you'll be successful. Other businesses might have already cornered the market or be poised to do so. For example, lots of small business owners who ran successful video rental businesses were wiped out when Netflix hit the market. It's often all too easy for a bigger, better-capitalized outfit to copy your best features and pull the rug out from under your business. Use this section to explain why your business really will have few direct competitors—or, if competitors will abound (as is far more likely), to show how your business will develop and keep an edge. Don't be shy about detailing competitors' strengths as well as weaknesses as part of showing why your business will better meet customers' needs.

In discussing the competition, it's important to put yourself in the shoes of a customer who is comparing your business to a competitor's. From the customer's perspective, what factors are most important

in choosing which business to patronize? Some obvious considerations are quality of products or services, convenience (access), reliability, and price. Your competitors will probably excel in some of these areas and be weaker in others. The same will probably be true of your business. The trick is for you to find a spot, or niche, among the competition, and offer a combination of elements—such as price and convenience—that no one else offers.

EXAMPLE: John wants to open a business to sell and service classic cars. In developing his business idea, he discovers that there are about a dozen existing companies within a 20-mile radius of his proposed location that already provide some or all of the services he envisions. Before finally committing to opening the business, he needs to identify and create a convincing competitive edge. One day, talking to a friend, he realizes that his edge could be a better system for sourcing vintage parts. If he could locate new and used classic car parts nationwide, rather than just in his region, he would have a huge advantage over other shops. John begins by developing a database of websites that specialize in classic and reproduction car parts, organized by make and model. By using these online dealers—plus other dealers nationwide who aren't online, but whom John will get to know as he attends regional trade shows and does more national business—John will be able to get parts faster than any of his competitors. Putting extra energy into the parts database gives John a key marketing hook to convince his knowledgeable (and often finicky) customers that his business really is a step ahead.

Businesses With Specialized Knowledge Are Hard to Copy

The business owner who knows the most about how to beat out competitors usually wins. But what is business knowledge, and how can you exploit it? In the broad sense, it's anything a business knows how to do that can give it a meaningful edge over competitors. Common examples include knowing:

- where to buy products for resale cheaper than competitors
- what would make a great location
- how to make a unique, hard-to-duplicate product
- how to provide excellent customer service, and
- that superior customer accessibility is critical to a particular business—longer hours or better parking, for example.

Consider the example of Laura and Brad's import business. They were importing clothing from Guatemala, but with competition from hundreds of other small importers, it was hard to make a dime. Leaving Brad to manage the business for a few weeks, Laura spent some time working with a dozen weavers in a small Guatemalan town. They focused on creating specially woven and dyed fabric suitable for luxury window coverings. Realizing that the high end of the import business was an underexploited niche, Laura quickly created a product with a hard-to-copy look and a solid profit margin. In short, she transformed a not particularly savvy, barely profitable import business into a highly intelligent, highly profitable one.



CAUTION

Think twice before competing on price. No matter how efficient your business is and how little you charge, someone will always charge less. Given the purchasing power and other efficiencies of big business, few small operators can successfully compete on pricing alone. Far better to look for another edge—quality, uniqueness, or customer convenience, to mention a few.

Marketing and Branding Strategy

In the customer targeting and competitive analysis sections of the business plan, you've shown that there are people out there who will buy your product or service from you instead of from your competitors. Great, but your job isn't done. Investors and others interested in supporting your business will want to know how you'll reach and connect with your customers in a cost-effective way. The answer to this question is, in a nutshell: marketing and branding strategy.



RELATED TOPIC

Learn about marketing and branding in Chapter 13: "Small Business Marketing 101." Refer to that chapter for a detailed explanation of crafting a marketing strategy and using cost-effective tools. For the purposes of your business plan, you'll need at least a cursory description of your marketing approach and how you envision your brand. Some businesses might want to go a step further and draft a separate marketing plan.

As described in more detail in Chapter 13, the term "marketing" refers to the activities you'll undertake to promote your business: social media outreach, media relations, advertising, and others, including branding. "Branding" falls under the marketing umbrella; it involves defining your company's identity and the feelings you hope customers will associate with it.

Any marketing strategy worthy of the name should be based on the particular characteristics of the market you're trying to reach, with the goal of reaching as many customers as possible for the least expense. For instance, if you're trying to reach a very tiny group of people, such as left-handed ophthalmologists, or even a slightly larger audience, such as digital video editors, it makes no sense to spend the big bucks required for television advertising. On the other hand, if your market consists of all children between the ages of six and ten, TV advertising at the right times and on the right channels might be an efficient way to reach them.

In your plan for reaching your customers, explain what methods you will use, such as social media promotions, special events, radio or newspaper advertising, or content marketing. If you plan to use nontraditional guerrilla marketing tactics, such as putting up posters all around town or staging publicity stunts, explain exactly what you plan to do. And no matter what kind of marketing strategy you outline, explain why you think it will work.

Small businesses that don't have much of a marketing budget shouldn't be shy about their smaller-scale plans. Even if you don't plan to spend much (if any) money on marketing or advertising, you should have a plan for how you'll reach your first customers. In your business plan, simply explain what this strategy is. The following example shows how a small business with a minimal advertising and marketing budget might explain its strategy.

EXAMPLE: Rather than spending money on traditional advertising, Turtlevision, a video postproduction firm, plans to keep its marketing costs very low, at least for the first year or two. The company plans to list its services in local video-related directories, join a couple industry associations, and use various online communities to promote the business. In addition, the company will offer services at a discount to various nonprofit organizations to develop a strong portfolio and to generate good word of mouth. (For example, it plans to offer discounted services to a nonprofit organization to stream educational videos online.) Turtlevision hopes that it will receive recommendations from satisfied customers that will give it a start in the right direction.



TIP

Marketing without advertising can be successful. Especially in niche or local markets, people often make purchasing decisions based on the recommendations of people they respect, not on ads. If you doubt this, think about how you chose your dentist or plumber or the company that recently fixed your roof. Chances are good that you got a recommendation from someone you trusted. but to be the beneficiary of positive word of mouth, you must run an excellent business.

Assuming you do, you can let potential customers know about your great service in many ways. See Chapters 13 and 14 for more on the subject of marketing.

Digital Strategy: Marketing and Selling Online

Your business's online existence should be thought out and addressed in your business plan. Ideally, you'll dedicate some of your planning process to big-picture thinking and planning about the digital side of your business; we offer guidance on how to do that in Chapter 14 on doing business online. If you do a thorough job of fleshing out your digital strategy, you'll want to share a condensed version of it in your business plan.

If you'll be engaged in e-commerce with sales conducted online, you'll want to address the e-commerce technologies you'll be using in the plan. If online sales are a significant part of your anticipated revenues, you'll want to give extra attention to your digital presence and offer a fair amount of detail about it in your business plan. If you don't intend for online sales to be a big part of your business's overall revenues, then it might be less essential to go deep with this planning. You'll still want to at least mention in your business plan the degree to which your business will have an online presence.



TIP

Every business needs to decide for itself how much to "go digital." It's not necessarily the wrong idea to focus on offline operations and sales. If you know your customers may be better reached offline, and you don't feel savvy in the digital sphere, it could be reasonable to forego the investment that digital outreach requires. Just be aware that short-shifting on the digital side may mean you're missing out on potential customers. Most businesses can boost business by engaging in some digital marketing, even just a little. We discuss digital strategy in-depth in Chapter 14.

Financial and Operational Technology

You will no doubt use multiple business software tools and services to operate your business. These back office technologies include financial software, customer databases, human resource software, and internal collaboration platforms, to name just a few. We discuss them further in Chapter 12. If you're new to the world of business tech, it's important not to underestimate the time it takes to competently manage the various technologies powering your business. It's highly advisable to take time during the business planning phase to map out the tech tools you plan to use, including their relationships with each other.

In your business plan, you can present an overview of these important systems. Doing so will undoubtedly be valuable to your team in getting a leg up on the task of setting all these systems up. If you plan to use your business plan to raise money, this overview will also help persuade potential funders that you've done your research and will be well-positioned to get the technology side of your shop set up efficiently and smartly.

Management and Staff Structure

Use this section to describe who will be working for your business and in what capacity. Obviously, include yourself and any co-owners (you'll provide details on your business accomplishments in the next section). Also, describe how many employees you plan to have, their duties and job descriptions, compensation rates and structure, and how any departments or lines of authority will be structured. Also include job descriptions and budgets for any regular contractors you plan to hire.



CROSS REFERENCE

We discuss hiring and managing staff in more depth in Chapter 16.

Another topic to address in this section is whether your staff will be working remotely or on-site, or a combination. There's no such thing as a standard approach to this question these days, and it's helpful to offer details on the ways your staff will collaborate in order to fill out the picture of your planned workplace(s).

In short, use this section of your business plan to offer a condensed version of your planned management approach and how you intend to run an efficient, effective operation. A little structure goes a long way when managing teams and collaborators. If you will use your business plan to raise money, your funders will definitely want to see a well-organized plan for day-to-day management of the business.

Business Résumé

Above and beyond demonstrating the beauty of your business, you'll want to show that you and any other key managers (whether they are owners or not) are the right people to run it. Do this by creating a résumé showing the business accomplishments of your management team. Here you have the chance to highlight all of your relevant experience and training, as well as any other personal information likely to inspire confidence in you as businesspeople.

Prospective lenders and investors will want to know a number of things about your management team:

- **Do you understand the business?** Emphasize that you and your managers understand the basic tasks of the business inside and out. Surprisingly, lots of people start small businesses in areas where they are amateurs. For example, a person who isn't mechanically inclined but who loves German cars might want to open a VW repair shop. Lack of hands-on experience will likely be a red flag to investors, who know a nonexpert boss can't roll up their sleeves and help out in emergencies. Do your best to show them otherwise.
- **Can you manage people?** All sorts of organizations, including small businesses, fail because their leaders—no matter how technically competent—don't know how to structure or manage teams, or simply have poor interpersonal skills. Ineffective people management is one of the surest ways to create a poor workplace atmosphere, one with low morale, mediocre productivity, and high turnover. If you have successfully worked with, and preferably led, people, you should emphasize this experience.
- **Do you understand money?** A surprising number of people who open small businesses don't know how to manage—or make—money. Even though their business idea is a good, competitive one and their employees are energetic, they make such poor financial decisions that their businesses don't prosper. Knowing this, people who will consider funding your business will want to see if you or another key person in your business has money management skills. If you do—even if your experience was in a very different business—emphasize it.

Making Financial Projections

In addition to describing how your business will work, including how it will reach plenty of customers and fend off competitors, you'll need to do some number crunching to show that your business will in fact turn a profit. All the rosy descriptions in the world won't make your business a success if the numbers turn up red.

Projecting the finances of your business might seem intimidating or difficult, but in reality, it's not terribly complex. Basically, it consists of making educated guesses about how much money you'll need to spend and how much you'll take in, then using these estimates to calculate whether your business will be sufficiently profitable.

Predicting and planning the finances of your business are critically important if you plan to seek start-up funding, through either lenders or investors. But even if you don't have plans to raise start-up money, you'll want to demonstrate to yourself that your business idea will fly. If your first projections show your business losing money, you'll have an opportunity while still in the planning stage to make sensible adjustments, such as raising your prices or cutting costs. If your projections show your customer base growing gradually, you can plan for how you will get through the initial lean months. If you neglect to make financial projections, you won't realize your plan is a money loser until you actually start losing money. At that point, it could be too late to turn things around.

Entrepreneur's Insight

Elissa Breitbard, founder of Betty's Bath & Day Spa in Albuquerque, New Mexico (www.bettysbath.com)

As time-consuming as it is to write a business plan, it is a critical factor to success—a symbolic security blanket. Our pre–start-up business plan bridged the chasm between the dream phase and a reality-based vision. In particular, churning out our first break-even analysis and cash flow statements was momentous, for the statements revealed the feasibility of our spa business. Even though the numbers weren't totally accurate (we had a lot more massage clients and fewer hot tub clients than projected), the important thing was to play with different scenarios and numbers and see that the business was, in fact, viable. The business plan helped us secure funding (not only from the bank, but also from family and friends) and provided me with a base of confidence—a concrete way to address some of the fears and issues that arise with taking a risk.

There's always talk about how many businesses fail; less discussed is the fact that the owners who have taken time to methodically set their business intentions in writing have a high rate of "making it."

Nonetheless, many new entrepreneurs avoid crunching their numbers, often due to fear that their estimates will be wildly off base and yield useless results. This is a poor reason to avoid forecasting your finances. If you do your best to make realistic predictions of expenses and revenues and accept that your guesstimates will not be absolutely correct, you can learn a great deal about what the financial side of your business is likely to look like in its early months and even years of operation. Even a somewhat inaccurate picture of your business's likely finances will be much more helpful than no picture at all.

For a basic understanding of your business's projected financial situation, you'll need to make the following estimates and calculations, all of which are discussed in detail in the rest of this chapter:

- **A break-even analysis.** Here you use income and expense estimates for a year or more to see whether, in theory at least, your business will be able to turn a profit. If you have trouble projecting a solid profit, you might need to consider abandoning your idea altogether.
- **A profit/loss forecast.** Here you'll refine the sales and expense estimates that you used for your break-even analysis into a formal, month-by-month projection of your business's net profit for at least the first year of operations.
- **A start-up cost estimate.** As the name suggests, this is simply the total of all the expenses you'll incur before your business opens. These costs should be included in your business plan to give a true picture of how much money you'll need to get your business off the ground.
- **A cash flow projection.** Even if your profit/loss forecast tells you that your business will have higher revenues than expenses, that doesn't mean that you'll always have enough cash available on key dates, such as when rent is due or when you need to buy more inventory. A cash flow projection lays out how much cash you'll have—or how much you'll be short—month by month. This lets you know if you'll need to get a credit line or set up other arrangements to make sure funds are available.

Entrepreneur's Insight

Clare Zurawski, Grants Specialist and Management Advisor at New Mexico Community Capital

I consider a cash flow projection to be the heart of any business plan. It's a fantastic planning tool because it reflects so many facets of the enterprise, from market research to product pricing and production cost management. For a start-up business, two sets of projections can be really useful: one conservative set assuming a slow ramp-up phase, and another set reflecting either moderate or aggressive growth. If the lower end of the range is unacceptable, some fine-tuning of your margins is probably necessary.

The best way to do your financial projections is to use spreadsheet software such as Google *Sheets* or Microsoft *Excel*. If you have never used spreadsheet software, take heart: It is quite easy to learn. Ask a friend to show you how it works or even tackle it yourself (many helpful tutorials are online), and in a couple of hours you'll likely be able to start your number crunching in earnest.

Get to Know Your Numbers

The calculations involved in accounting aren't terribly complex. The main reason people get confused is not that they're bad at math—it's that they don't understand what the numbers mean. It's important that you take a little time early on to learn what your key financial numbers are, and how they relate to one another. To help you keep the numbers straight, keep in mind this formula:

	Sales revenue
–	Costs of sale (variable costs)
=	Gross profit
–	Overhead (fixed costs)
=	Net profit
–	Taxes
=	After-tax profit

You'll have a much easier time understanding all the various financial calculations involved in accounting—including break-even, profit/loss, and cash flow analysis—once you're familiar and comfortable with this basic formula.

It usually makes sense to develop your initial financial projections with spreadsheet software and not the full-featured accounting software that you should use to track your actual income and expenses once your business launches. Accounting programs such as *QuickBooks* or *Wave Accounting* work great for ongoing bookkeeping and financial management, but not for developing estimates and projections.

The rest of this chapter will walk you through each of these financial forecasts. When you're done, you should be able to tell whether your business will actually make enough money to pay the bills and turn a profit. Assuming the answer is yes, you'll also see whether you need to obtain start-up money from investors or lenders and, if so, how much. Finally, once your business is up and running, you can refer back to your forecasts to see how your performance is measuring up.

Break-Even Analysis

Your break-even point is the point at which the income you'll bring in just covers your expenses. Expenses include the costs of providing your product or service (also known as variable costs, because they change depending on how many products or services you provide), plus your overhead, like rent, salaries, and utility bills (commonly called fixed costs).



FORM

Break-Even Analysis Worksheet. The Nolo website includes a downloadable interactive worksheet to help you calculate your break-even point. See the Appendix for the link to this worksheet and other forms in this book.

Because break-even analysis offers a glimpse of your ultimate profitability, it's a great tool for weeding out losing business ideas. For example, if you see that you'll need to achieve a highly optimistic sales number just to cover your costs, you should rethink your entire business plan. Maybe you'll figure out a way to adjust parts of your business so that you can realize a profit from lower sales. If not, it might be best to ditch your less-than-brilliant business idea.

To find your break-even point, first make a best-guess estimate of your sales revenue for the products or services you plan to sell. Then predict how much profit you'll make on each sale (by subtracting the costs of the sale from the revenue it generates) and figure out a "gross profit percentage," which tells you how much of each sales dollar exceeds the cost of the product or service itself. Finally, estimate what your fixed costs, such as rent and insurance, will be. After a few calculations, you'll see whether the profit you'll make on each individual sale (also called gross profit) will cover your fixed costs.

Before examining the details of calculating your break-even point, let's look at a simple example to illustrate the overall process. All the calculations are explained in more detail below; for now, just focus on the process as a whole.

EXAMPLE: Michele is starting a side business selling her handmade jewelry. To calculate her break-even point, she makes her best estimate of how much jewelry she thinks she could sell in a year. She figures she could sell an average of 20 pieces a month at $20 apiece, making her yearly income $4,800. Then she figures out how much she'd make on each sale, above the cost of materials. (For this super-simplified example, let's leave the cost of her time out of the equation.) Because the materials for each piece cost Michele $5, she'd be making $15 on each sale. In other words, her gross profit would be $15 per piece.

Next, she calculates her gross profit percentage, which is her gross profit ($15) divided by her selling price ($20). This puts her gross profit percentage at 75%, which means that $0.75 of each sales dollar exceeds the cost of the piece of jewelry itself.

Next, Michele would figure out what her fixed costs would be—say, the cost of her tools and the monthly fee for her booth at a local arts and crafts mall. She figures that these fixed costs total $50 per month, or $600 per year.

To calculate her break-even point, Michele will divide her annual fixed costs ($600) by her gross profit percentage ($0.75) to arrive at a break-even point of $800. This means that just to cover the costs of the materials and her tools and booth, Michele must bring in $800 per year. Anything

above that amount will be her pretax profit. Because she earlier estimated that she could sell $4,800 worth of jewelry per year, Michele figures that she'll easily reach her break-even point—and make a $4,000 profit, as well.

Here's what it looks like in spreadsheet form:

Michele's Break-Even Point

Annual pieces sold	240	
Price per piece		$20
Annual revenue	$ 4,800	
Variable costs per piece		$ 5
Gross profit per piece		$15
Gross profit	$ 3,600	
Gross profit %	75%	
Fixed costs	$ 600	
Break-Even Point	$ 800	

Before explaining exactly how to do the calculations, this chapter quickly discusses two items that you need to understand before actually crunching your numbers: making financial estimates and categorizing your expenses.

Making Estimates

When you estimate your income and expenses, your estimates should extend over enough time to catch up with seasonal fluctuations. Depending on your type of business, your revenue and expenses might vary wildly from month to month. For example, if you plan to manufacture custom snowboards, most of your sales will be in the late fall and early winter months, while sales of swimwear would likely peak in spring and early summer (with spikes around typical holiday travel times). A good way to account for this is to make estimates for each month of the year, then add them up to get a yearly figure. In making these estimates, it is wise to cover at least a one-year period, which is enough time to account for normal ups and downs, but not so long as to be overly speculative.

Categorizing Your Expenses

Your business expenses break down into two categories: fixed expenses (fixed costs) and variable expenses (variable costs). Not only is this division important for your break-even analysis, it's also a standard method of categorizing expenses for accounting and tax reporting. The differences are:

- **Fixed costs.** Commonly referred to as "overhead," these include all regular expenses not directly tied to the product or service you provide. Rent, utility bills, phone bills, payments for outside help (such as bookkeeping services), postage, and most salaries (except in service businesses) are common fixed costs.
- **Variable costs.** These costs—sometimes also called product costs, costs of goods sold (COGS), or costs of sale—are directly related to the products or

services you provide. Variable costs include inventory, packaging, supplies, materials, and sometimes labor used in providing your product or service. They're called "variable" precisely because they go up or down depending on the volume of products or services you produce or sell. In the case of services, one of the biggest variable expenses is almost always the wages or salary of the service provider. (See "Salaries and Labor Costs—Fixed or Variable?" below, for a more complete explanation.)

Estimate Your Sales Revenue

Start your break-even analysis by making your best estimate of annual sales revenues. Your estimate will depend on several variables, such as your type of business, what you plan to charge for each product or service you'll offer, and how successful you'll be at selling products and services.

Though at first it might seem overwhelming to project revenues based on so many untested variables, it is essential that you take the plunge and try out some numbers. Even though your estimates won't be anywhere near 100% accurate, they'll force you to focus and refine elements of your business idea and can even help you spot big potholes in your plan. And besides, you need these estimates before you can move ahead with your break-even calculations, so get over it and start estimating.



RELATED TOPIC

Pricing help still to come. Figuring out how much to charge for your goods and services is addressed separately, in Chapter 6, where you'll also find info on service billing options and how to put together solid bids and proposals.

One good way to estimate how much money you'll be bringing in is to compare your business to similar ones. Retail businesses, for example, often measure annual sales revenue per square foot of retail space. Thus, if you plan to open a pet supply store, you'll want to find out the annual sales revenue per square foot of other pet supply shops. Direct competitors probably won't share this information with you, but industry trade publications almost always provide it. Attending industry trade shows where you can meet and talk with people who own similar businesses in other parts of the country is another good way to gather valuable information.

EXAMPLE: Inga is planning to open a used book-store in Milwaukee called Inga's Book Haus. She plans to sell mostly used books, which generally have a high profit margin, but she'll also stock a limited selection of new books at the front of the store to attract more customers. She'll also sell some miscellaneous trinkets, such as postcards and magnets.

To figure out how much sales revenue she can realistically expect for Inga's Book Haus, Inga calls a couple of friends who are in the book business.

One who works at a nearby used bookstore confides to Inga that the store sells approximately $450 worth of books per square foot per year. Another friend owns a new-and-used bookstore in Madison; she tells Inga that they bring in about $400 annually per square foot. Neither of these stores is exactly like the one Inga envisions; the one in Milwaukee doesn't sell new books, and the one in Madison does a healthy trade in textbooks, which Inga doesn't expect at her store. To round out her information, Inga also looks into some trade publications and does a bit of sleuthing at local new-and-used bookstores, examining their prices and how busy they seem to be. Ultimately she decides that an annual income of $350 per square foot is realistic. She has her eye on a few storefronts, all around 1,200 square feet, so she estimates her annual revenues to be $420,000.

Salaries and Labor Costs—Fixed or Variable?

Whether you'll categorize labor expenses as fixed or variable costs often depends on the type of workers you pay and the kinds of products or services you're selling. Salaries or wages of the managers and employees who are necessary to keep your business going (you or your bookkeeper, for example) are usually best seen as fixed costs. But salaries or wages for employees who create the products or provide the services you sell might be more appropriately treated as variable costs. For example, an ad agency that pays six freelance copywriters to service clients' accounts should treat their paychecks as variable costs. To figure out whether a labor cost should be designated as fixed or variable, ask yourself: If I sell twice as many products or services this week, will my labor costs go up? If not, you're probably looking at a fixed cost. For instance, suppose you're trying to decide whether your office manager's salary should be categorized as a variable or categorized as a variable or fixed cost. If you produce and sell 100 more Snuggie blankets, will your office management costs go up? Probably not. (However, the team shipping and fulfilling orders will likely put in more hours.) So, your office manager's salary should be part of your overhead. But if you have to hire five temporary employees to answer the phones at Christmastime to handle the spiking demand for Snuggies, their wages should be classified as variable costs. (Hint: Money paid to workers who are temps or independent contractors is usually categorized as variable costs, because those payments are usually tied to providing a product or service.) Of course, if you sell more products or services regularly, you'll probably decide to expand your business and increase your overhead, because you'll have to hire more support staff, managers, and other necessary employees just to get along. At that point, you might revisit your allocation of fixed and variable costs.

Basing your projected revenue on the numbers of similar companies also works for nonretail businesses such as wholesaling or manufacturing companies—but it can be somewhat tricky to find a solid basis for comparison. Unlike retail businesses, sales per square foot doesn't really apply. If you're not already well acquainted with your field, you'll have to do some research. Study similar businesses to find out how many employees they have, how wide their distribution is, and how much annual income they earn. Base your income projections on similarly sized businesses with a comparable range of distribution.

If yours is a service business, your estimate of sales revenue will depend on how many billable sales you'll be able to make each month. A big part of this calculation is how many hours you and any employees will work and how much you'll be paid per hour by your clients. But don't overlook the fact that all of your time won't be billable—you won't be providing services every hour you're at work. For example, if you run a landscaping business, a sizable portion of your time will be spent not performing landscaping work but managing your accounts, maintaining your equipment, and soliciting new clients. To get an accurate picture of how much money will be flowing in, you'll need to make a realistic assessment of how much of your time will be taken up by these nonbillable activities and how much time you'll spend providing actual services to clients.

Calculate Your Average Gross Profit Percentage

Your next task is to figure your average gross profit percentage. It might sound complex, but it's just a figure that represents how much of each sales dollar will be left over after paying for the costs of the products or services themselves.

A number of steps are involved in calculating this figure, but none involves anything more than simple math: addition, subtraction, multiplication, and division. The formula described below might seem a bit complicated because it calculates gross profit percentage for separate categories of your products and services, then uses those category-level percentages to yield a gross profit percentage for your sales overall. As described below, this approach helps develop a more precise estimate.

Once you know your average gross profit percentage, you'll easily be able to figure out how much money you'll need to bring in to cover all the costs of your business.

In a nutshell, to figure your average gross profit percentage, you'll:

1. figure out your gross profit for each major category of your products or services
2. determine an average gross profit for your business overall, including all your products and services, and
3. divide your average gross profit by your average selling price.

In case you're wondering what the difference is between "gross profit" and "average gross profit," here's a quick explanation. (The details will be covered while going through the calculations, below.) When you sell an individual product, the money that you earn above the cost of the item itself (called your variable cost, or sometimes cost of goods) is called gross profit. For instance, if your pet store sells a doghouse for $200, and you bought the doghouse for $110, then what's left over for you after the sale is $90: your gross profit. This is often referred to as your profit margin. If your business sells more than one kind of product, you'll need to calculate an *average* gross profit for your total product line to get a realistic figure. The average gross profit for your pet store would include all of your products in the calculation—cat scratching posts, pet food, play toys, and so on—including their sales prices and what they cost you.

The next few subsections take you through the process of calculating your business's average gross profit.

Figure Your Gross Profit by Category

As described above, your gross profit is the amount of money you make on each sale, above what it costs you for the product or service itself—that is, the variable cost or cost of sale. Gross profit is determined by subtracting the variable cost of your product or service from its sales price.

Variable costs are generally fairly easy to estimate. If you're selling products bought from a wholesaler, your variable costs might be as simple as what you pay for the products themselves. If you'll assemble the products, include your costs for the parts and labor needed to put them together. Also remember to include items such as packaging or freebies in your variable costs.

If you sell only services, variable costs basically include what you pay to whomever provides the services (you or perhaps an employee), not including time spent on administrative tasks and managing accounts, which is generally considered to be a fixed, not variable, cost. It can sometimes be tricky to figure out the variable costs of a service business. Do your best to separate out the costs that are not associated with individual projects—those are your fixed costs.

EXAMPLE: Turtlevision, a digital video editing service, pays its staff editor $50 per hour for 80 hours per month of editing work. In addition, Turtlevision pays an office assistant $15 per hour for 100 hours per month of administrative work. Turtlevision's monthly variable costs would include the editor's salary of $4,000, but not the salary paid to the office assistant, which is not tied to any particular client or project.

One important factor in figuring out your business's gross profit is that your selling prices and variable costs can vary a great deal from product to product (or service to service). For instance, say you buy cat collars for an average of $4, and sell them for an average price of $10 (your gross profit per cat collar would be $6). Doghouses, on the other hand, cost you an average of $110, and you sell them for an average price of $200 (your gross profit per doghouse would be $90).

To account for these differences, you should categorize your products or services and figure an average gross profit for each category. There are a few steps to follow, but hang in there—each one is pretty simple.

First, estimate the average selling price and average variable cost for products or services with roughly similar selling prices and variable costs. For instance, you might group all your animal collars together—for cats, dogs, and ferrets—because their selling prices ($9 to $13) and variable costs ($3 to $5) aren't too different. Don't lump together products or services with considerably different selling prices or variable costs. As a general rule, the more tightly you define your categories, the more accurate your estimates will be.

After you've estimated the average selling price and average variable cost for each category, subtract the average variable cost from the average selling price for each category, and you'll have an average gross profit dollar figure for each category.

	Animal collars	Bird-houses	Dog-houses
Average selling price	$ 11	$ 60	$200
− Average variable cost	4	30	110
= Average gross profit	$ 7	$ 30	$ 90

The next step is to figure out a gross profit percentage for each category. A gross profit percentage tells you how much of each dollar of sales income is gross profit. To calculate each category's gross profit percentage, divide the average gross profit figure by the average selling price.

Animal collars category:

Average gross profit	$ 7
÷ Average selling price	$ 11
= Gross profit percentage	63.6%

Using the above example, it follows that if you sold $1,500 in cat collars, 63.6% of that—$954—would be gross profit, or the amount left over after paying costs of sale. As you can see, converting your gross profit into a percentage allows you to quickly figure out how much of your income will be left over after variable costs have been covered.

Calculate Your Average Gross Profit

After you've found the gross profit percentage for each category, you'll be able to determine your average gross profit for your business as a whole.

First, estimate your annual sales revenue per category. Earlier you estimated your total annual sales revenues; now divide that figure as best you can into your estimates for each category. For example, if you estimated total annual revenues of $100,000 for your pet supply business, divide that among your categories, such as collars, birdhouses, and doghouses—say, $25,000 in collar sales, $40,000 in birdhouses, and $35,000 in doghouses. Base your division on your best sense of which categories and products will make up a big part of your business, and which will have a smaller share. Then, for each product category, multiply the estimated sales revenue by the category's gross profit percentage (arrived at above) to figure out your total gross profit dollars per category.

Animal collars category:

	Estimated sales revenue	$ 25,000
×	Gross profit percentage	63.6%
=	Total gross profit	$ 15,900

Finally, add together the gross profit dollar amounts for each category to arrive at a total annual gross profit for your business. Divide the total annual gross profit figure by the total annual sales that you estimated for all products or services. The result will be an average gross profit percentage for your business.

Let's return to the example of Inga's Book Haus for another look at how the process works.

EXAMPLE: As you might recall, Inga plans to sell new and used books, plus some peripheral items, such as postcards and refrigerator magnets. Because the profit margins for new books, used books, and trinkets are different, Inga figures a gross profit percentage for each of these categories. (Inga might want to establish separate categories for hardback, paperback, and coffee-table books, but we'll keep things simple.)

To accomplish this, first Inga estimates an average variable cost for each category. In addition to the cost of the merchandise, she includes the cost of free bags, bookmarks, and wrapping paper for gifts, for a total average variable cost of $3.08 per used book sold. She doesn't include fixed costs, such as rent or salaries.

Next, Inga fills in an average selling price for each product category. Her average selling price for used books, for example, is $7. She then subtracts the average variable cost (arrived at above) from the average selling price to get an average gross profit figure for each product category. Subtracting her average variable cost for used books ($3.10) from her average selling price for used books ($7) leaves her with an average gross profit for used books of $3.90.

Used book category:

	Average sales price	$ 7.00
–	Average variable cost	3.10
=	Average gross profit	$ 3.90

Inga does the same calculation for new books, which shows an average gross profit of $4.00, and trinkets, which has an average gross profit of $1.40.

To determine the gross profit percentage, she'll simply divide the gross profit by the selling price in each category to get a gross profit percentage for each category. Dividing her average gross profit for used books ($3.90) by her average selling price ($7) gives Inga a gross profit percentage of 56% for used books. That means that for every dollar she'll bring in from used books, $0.44 will be eaten up on Inga's costs, leaving $0.56 to cover fixed costs and go towards a net profit. Her gross profit percentage is 33% for new books and 70% for trinkets.

New book category:

	Average gross profit	$ 4.00
÷	Average selling price	12.00
=	Gross profit percentage	33%

Trinkets category:

	Average gross profit	$ 1.40
÷	Average selling price	2.00
=	Gross profit percentage	70%

Using the gross profit percentages and estimated sales revenues for each category, Inga can calculate the gross profit dollar figure for each category. For example, her estimated annual sales of used books is $300,000. (Remember that Inga estimated her total annual sales revenue to be $420,000. She thinks used books will account for a little over two-thirds of her sales.) By multiplying $300,000 by the used book category's gross profit percentage (56%), she estimates an annual gross profit of $168,000. Adding up the gross profit figures for each category, Inga figures that her total gross profit will be $215,000. Finally, by dividing this amount by her annual estimated revenues of $420,000, she easily determines her overall average gross profit percentage, which is 51.2%.

		New books	Used books	Trinkets
	Average selling price	$ 12.00	$ 7.00	$ 2.00
–	Average variable cost	8.00	3.10	0.60
=	Average gross profit	$ 4.00	$ 3.90	$ 1.40
	Average gross profit	$ 4.00	$ 3.90	$ 1.40
÷	Average selling price	12.00	7.00	2.00
=	Gross profit percentage	33%	56%	70%
	Average sales	$ 100,000	$ 300,000	$ 20,000
×	Gross profit percentage	33%	56%	70%
=	Annual gross profit	$ 33,000	$ 168,000	$ 14,000

Annual gross profit:

	New books	$ 33,000
+	Used books	168,000
+	Trinkets	14,000
=	Total annual gross profit	$ 215,000
÷	Total annual sales	$ 420,000
=	Average gross profit percentage	51.2%

Estimate Your Fixed Costs

You're done with the hard part. Compared to calculating your gross profit percentage, fixed costs are a breeze. Simply estimate your monthly fixed expenses, including items such as rent, utility bills, office supplies—basically, any anticipated costs that don't depend on the product or service you sell. Because many of these costs recur monthly, it's usually easiest to estimate them per month and total them for one year. It's also a good idea to throw in a little extra (10% or so) to cover unpredictable miscellaneous expenses. Once you've arrived at a total, you'll know you'll need to make at least this much gross profit (and probably more) to keep your business afloat.

EXAMPLE: Here is a list of Inga's monthly estimates for fixed costs.

	Rent	$ 3,500
	Wages for part-time clerks	2,500
	Utilities	800
	Telephone	700
	Office equipment	700
	Insurance	500
	Advertising	700
	Accounting	300
	Electronic payment system fees	300
	Misc.	1,000
	Total fixed expenses per month	$ 11,000
	Total fixed expenses per month	$ 11,000
×	Number of months in a year	12
	Annual total fixed expenses	$ 132,000



CAUTION

Don't forget you have to eat. Notice that Inga has chosen not to list a salary here as an expense. She, like many solo operators, figures that her savings, help from friends and family, and some extra crumbs the business produces should be enough to live on for the short term. Once she figures out how much profit the business will bring in regularly, she'll decide how much profit she can expect to take out of the business and add that number to her fixed costs. Leaving out payments for your own living expenses in your break-even analysis, however, can be dangerous, particularly if you're planning to live off your business's profits from the get-go. If this is your plan, you should add to your fixed costs the minimum amount you'll need to take out of the business to cover your living expenses. Then, if you can't project your income to be higher than your fixed costs when the amount you'll need for living expenses is included, you'll know you can't plan on living off the company. This could be a clue that your business is not a good bet.



TIP

Keep fixed costs as low as reasonably possible. If your business is slow to get started—and lots of businesses take months or even years to become solidly profitable—high fixed costs can quickly eat up your savings. Rather than committing yourself to high overhead, it's usually better to keep expenses low, allowing increases only when your income justifies spending more. For example, few businesses really depend

on a pricey physical location for their success. If your business won't depend on a big casual walk-in trade, don't overpay for a trendy zip code. Operating from a low-cost warehouse district, an older office building, or even your garage could work just fine, at least at the beginning.

Calculate Your Break-Even Point

Once you have estimated your average gross profit percentage and your fixed costs, it's easy to figure out how much revenue you'll need to break even. Remember, your gross profit percentage represents how much of each dollar of revenue is actual profit, left over after paying for the product or service itself. To figure out your break-even point, you'll divide your estimated annual fixed costs by your gross profit percentage. The result will be the amount of sales revenue you'll need to bring in just to cover your costs.

EXAMPLE: The break-even point for Inga's Book Haus will equal her annual fixed expenses divided by her average gross profit percentage.

	Annual fixed expenses	$ 132,000
÷	Average gross profit percentage	51.2%
=	Break-even point	$ 257,813

If you're having trouble understanding how this equation works, you're not alone. Conceptually, it's a little tricky to see how dividing your fixed costs by your gross profit percentage yields your break-even point. Think of it this way: However much money your business brings in, some of it will be eaten up by the cost of the product or service itself (your variable costs), leaving you a reduced amount left over to pay your bills. How much is left over is determined by your gross profit percentage—this number tells you just how much will be left over, on average, from each dollar, after paying for your product or service itself (your variable costs). When you divide your estimated annual fixed costs by your gross profit percentage, the resulting number (the break-even point) is the exact amount that's enough to cover your fixed costs.

Here's Inga's break-even analysis, prepared using the downloadable interactive worksheet on the Nolo website. See the Appendix for information about accessing the form.

Break-Even Analysis Worksheet

STEP 1: Estimated Total Annual Revenues

$420,000

STEP 2: Gross Profit Percentage by Category

Category 1: New Books

Average sales price	$12.00
Average variable cost	$8.00
Average gross profit:	$4.00
Gross profit percentage	**33%**
Estimated annual revenues	$100,000
Total estimated gross profit	$33,000

Category 2: Used Books

Average sales price	$7.00
Average variable cost	$3.10
Average gross profit	$3.90
Gross profit percentage	**56%**
Estimated annual revenues	$300,000
Total estimated gross profit	$168,000

Category 3: Trinkets

Average sales price	$2.00
Average variable cost	$0.60
Average gross profit	$1.40
Gross profit percentage	**70%**
Estimated annual revenues	$20,000
Total estimated gross dollars	$14,000

Estimated Annual Gross Profit

Total estimated gross dollars, all categories	$215,000
Total estimated annual revenues	$420,000
Average Gross Profit Percentage	**51.2%**

STEP 3: Estimated Annual Fixed Costs

Rent	$3,500
Wages for part-time clerks	$2,500
Utilities	$800
Telephone	$700
Office equipment	$700
Insurance	$500
Advertising	$700
Accounting	$300
Electronic payment system	$300
Miscellaneous	$1,000
Total Monthly Fixed Costs	$11,000
Total Estimated Annual Fixed Costs	**$132,000**

RESULT

Break-Even Point

Estimated Annual Fixed Costs	$132,000
Average Gross Profit Percentage	51.2%
Break-Even Point	**$257,813**

Analyze Your Result

If your estimated revenue exceeds your break-even point, great—but that's not the same thing as saying you are free to put the excess money in your pocket. Again, remember that every dollar you bring in doesn't come for free; you had to pay something for the cost of your product or service (variable costs). The portion of excess sales revenue that's really yours (ignoring taxes for the moment) is equivalent to your gross profit percentage of that excess revenue. To determine how much of the excess revenue is pretax profit, multiply the excess by your gross profit percentage. The result is your estimated net profit.

EXAMPLE: Earlier, Inga (the used bookstore owner) estimated her annual sales revenue to be $420,000—over $160,000 more than she needs to break even.

	Estimated revenue	$ 420,000
–	Break-even point	257,813
=	Excess revenues	$ 162,187

To figure out how much of her excess revenue will be actual pretax profit, Inga multiplies it by her gross profit percentage.

	Excess revenues	$ 162,187
×	Gross profit percentage	51.2%
=	Net profit	$ 83,040

Inga is happy to see her projections show a profit. But she needs to remember that none of her estimates included any payments to herself, meaning she'll probably need to take some of that net profit just to meet her living expenses.

If, on the other hand, your break-even point is higher than your expected revenues, you'll have some decisions to make. For example, you'll have to decide whether certain aspects of your plan can be amended to come up with an achievable break-even point. For instance, perhaps you could find a less expensive source of supplies, do without an employee, or save rent by working out of your home.

But don't change your numbers without a very good reason. When confronted by a break-even point that exceeds your estimated revenues, you might be tempted to boost your sales estimates in hopes that you'll somehow be able to pull it off. Try to resist this temptation unless you have a good reason to believe that you can actually hit a higher sales number.

If your break-even point exceeds realistic revenue estimates, you'll need to reduce your costs, thereby reducing your break-even point. The most reliable way to tilt a business from the red to the black is to reduce what you will pay out, not to make a more optimistic projection of what you'll take in.

Profit/Loss Forecast

If your break-even analysis shows that, based on realistic estimates of revenue and expenses, your business will turn a profit, your next job is to use these figures to create the profit/loss forecast component of your business plan. Similar to a break-even

analysis, a profit/loss forecast (sometimes called a P & L forecast) uses your estimates for sales revenue and variable costs to calculate your gross profit, then subtracts your fixed expenses from gross profit to arrive at net profit.

If you use accounting software, it will generate a P & L statement automatically once you enter monthly sales and expense estimates. You can also use the worksheet on this book's companion page on Nolo.com, as described below.



FORM

Profit/Loss Forecast Worksheet. The Nolo website includes a downloadable interactive worksheet to help you do a profit/loss forecast. See the Appendix for the link to this worksheet and other forms in this book.

The main difference between a P & L and a break-even analysis has to do with the time period it evaluates. A break-even analysis looks at profit and loss as an annual snapshot, while your P & L forecast tracks monthly net profit. A P & L forecast also differs from a cash flow projection (discussed below) in the kinds of income and expenses that it includes. A cash flow projection looks at all sources of income and expenses, including loans, transfers of personal money into the business, start-up costs, and all other types of cash inflows and outflows. A P & L forecast, on the other hand, is only concerned with money earned from normal business operations.

For this reason, a P & L forecast will tell you whether your business operations are generating enough income to cover your expenses, which is something you can't glean from a cash flow projection.

Here's how to translate your break-even figures into a profit/loss forecast: Start by breaking down your annual sales estimate into monthly amounts. If you expect significant seasonal fluctuations in sales, account for them here.

Next, figure your gross profit for each month. The easiest way to do this is to multiply each month's sales revenue by the gross profit percentage for your business as a whole, which you calculated earlier. (If you rounded off your gross profit percentage, you'll get a slightly different gross profit figure here than you did in your break-even analysis.)

Enter your monthly fixed expenses by category, and add them together to get monthly totals. Then, for each month, subtract your total fixed expenses from your gross profit and enter the result in the net profit row. If the result is a negative number, it means your expenses are more than your gross profit. Put parentheses around the result; in accounting symbols, a number in parentheses is a negative number.

EXAMPLE: Inga's one-year profit/loss forecast for her bookstore is shown earlier in this chapter.



CAUTION

Your profit/loss forecast doesn't include the whole picture. Other income and costs such as loans and start-up expenses aren't included in your P & L forecast, which reflects only money earned and spent as part of providing your products or services. For the full picture of all money that comes into and goes out from your business—including start-up costs, loans, taxes, and other money that isn't earned or spent as part of your core business operation—you'll need to do a cash flow analysis. (See "Cash Flow Projection," below, for a complete explanation.)

A completed P & L forecast will outline your business's profitability month by month. If your expenses are higher than revenues for a month or two, don't panic—most start-up businesses lose money for at least a few months—but you will need to figure out how to make it through these lean months (for example, by getting a start-up loan). More important in the big picture is whether you can see a trend toward stable profitability. If not, you might need to revisit parts of your plan (or possibly scrap your idea altogether). But, as mentioned earlier, resist the temptation to inflate your sales estimates; a more realistic approach is to lower your costs. Once you profits each month, based on realistic estimates, you're ready to move forward.

Start-Up Cost Estimate

If your profit/loss forecast shows your projected income will be higher than expenses each month, that's a positive sign. But beware that you haven't yet accounted for an important category of expenses: business start-up costs. The worst part about start-up costs is that you need to pay them before your business is actually making any money. That's why you should have a firm grasp on what you really need to spend to successfully start your business, along with a plan for where that money will come from. Of course, potential lenders or investors will want to see that you've accounted for these costs in your planning. But it's also important that you understand for yourself how high this initial financial hurdle will be so that you can figure out how to clear it. Obviously, you don't want to start a business with high start-up costs but low projected profits, because it will take you far too long to recover your initial investment.



CAUTION

Buy only what your business really needs. Too many new small business owners weigh down their new enterprises with unneeded start-up costs. Unless a particular item is absolutely necessary to generate revenue, don't buy it—or, if you do, spend as little as possible on it. Sure, you need a desk, but unless customers will see it (and sometimes even if they will), buying a secondhand desk for $80 makes a lot more sense than paying $800 for a new one.

Inga's Book Haus Profit/Loss Forecast: Year One Total

	Jan	Feb	Mar	April	May
Sales Revenues	$ 30,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000
Gross Profit (51.2%)	15,360	17,920	17,920	17,920	17,920
Fixed Expenses					
Rent	4,500	4,500	4,500	4,500	4,500
Salaries	2,500	2,500	2,500	2,500	2,500
Utilities	250	250	250	250	250
Telephone	250	250	250	250	250
Office Equipment	700	700	700	700	700
Insurance	500	500	500	500	500
Advertising	700	700	700	700	700
Accounting	300	300	300	300	300
Fees for Electronic Payment System	300	300	300	300	300
Miscellaneous	1,000	1,000	1,000	1,000	1,000
Total Fixed Expenses	11,000	11,000	11,000	11,000	11,000
Net Profit (Loss)	$ 4,360	$ 6,920	$ 6,920	$ 6,920	$ 6,920

June	July	Aug	Sept	Oct	Nov	Dec	Year Total
$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 40,000	$ 420,000
17,920	17,920	17,920	17,920	17,920	17,920	20,480	215,040
4,500	4,500	4,500	4,500	4,500	4,500	4,500	54,000
2,500	2,500	2,500	2,500	2,500	2,500	2,500	30,000
250	250	250	250	250	250	250	3,000
250	250	250	250	250	250	250	3,000
700	700	700	700	700	700	700	8,400
500	500	500	500	500	500	500	6,000
700	700	700	700	700	700	700	8,400
300	300	300	300	300	300	300	3,600
300	300	300	300	300	300	300	3,600
1,000	1,000	1,000	1,000	1,000	1,000	1,000	12,000
11,000	11,000	11,000	11,000	11,000	11,000	11,000	132,000
$ 6,920	$ 6,920	$ 6,920	$ 6,920	$ 6,920	$ 6,920	$ 9,480	$ 83,040

Compared to the projections explained earlier, estimating your start-up costs is a breeze—just list them and add them up. Include items like business registration fees and tax deposits you need to pay up front; rent and security deposits you'll have to pay before business starts; and costs of any initial inventory, office supplies, equipment, and anything else you'll have to cover before your business starts bringing in money.

EXAMPLE: Inga makes a list of the start-up expenses she expects to pay before she'll start selling books.

Initial inventory	$	15,000
Shelving and furniture		5,000
Rent deposit (security deposit and last month's rent)		7,000
Office supplies, stationery		500
Point-of-sale tablet		500
Business registration fees		200
TOTAL START-UP EXPENSES	$	28,200

If you don't have enough cash to pay all of your start-up costs out of pocket, you'll need to either come up with the money or figure out a way to spread the costs over the first few months of business, when you'll have at least some cash flowing in. For instance, maybe you could lease, rather than buy, needed equipment.

The next and final financial projection you'll need to do as part of your business plan—a cash flow projection—will help you plan and manage your incoming and outgoing cash so that you can cover needed expenses when they come due.

Cash Flow Projection

To round out the collection of financial information in your business plan, you should include a cash flow projection. Though your profit/loss forecast might show that your business should make enough sales at a high enough price to cover your estimated expenses, a cash flow projection analyzes whether the cash from those sales, as well as from other sources, such as loans or investments, will come in fast enough to pay your bills on time. Cash flow management is important once your business is up and running, especially if you plan to stock a good-sized inventory or extend credit to customers. A high sales volume won't be enough to cover your expenses if your customers are slow to pay you and your checking account is empty.



FORM

Cash Flow Projection Worksheet. The Nolo website includes a downloadable interactive worksheet to help you do a cash flow forecast. See the Appendix for the link to this worksheet and other forms in this book.

Cash flow projection is also important in your planning stages. It shows how you intend to survive the first few lean months of business—particularly after you figure in your start-up expenses. If you'll have more than enough cash to cover your expenses for the first months of business, you're one of the lucky few. More likely, you'll be pressed to figure out how to cover a cash deficit for at least the first few months, and maybe longer. One way to do this is to put off or cut some expenses. Another is to hit up your family or friends for a loan, find a bank or another lender willing to provide a start-up loan (which is much easier said than done), or sell part of your business to investors. The important thing is to do your best to predict your cash needs in advance, both to give yourself ample time to come up with a plan for getting the cash and to inspire more confidence in lenders or investors.

Your cash flow projection will use many of the same figures you developed for your profit/loss forecast. The main difference is that you'll include all cash inflows and outflows, not just sales revenues and business expenses. Also, you'll record costs in the month that you expect to incur them, rather than simply spreading annual amounts equally over 12 months. Inflows and outflows of cash that belong in your cash flow analysis include loans, loan payments, and start-up costs. Once you're turning a profit, you'll also include income tax payments in your cash flow analysis, but, for now, assume that you'll be free from income taxes for your first year.

For each month, start your projection with the actual amount of cash your business will have on hand. Next, fill in your projected cash-ins for the month, which should include sales revenues, loans, transfers of personal money—basically, any money that goes into your business checking account. Add these together along with the cash you have at the beginning of the month to get your total cash-ins for the month.

Next, enter all your projected cash-outs for the month, such as your fixed expenses and any loan payments. Remember also to include costs of products and materials you use in your products or services—your variable costs. Add together all your cash-outs to obtain a total for the month. Subtract total monthly cash-outs from total monthly cash-ins, and the result will be your cash left at the end of the month. That figure is also your beginning cash balance at the start of the next month; transfer it to the top of the next month's column, and do the whole process over again.

Inga's Book Haus Cash Flow Projection: Year One

	Dec	Jan	Feb	Mar	April	May
Cash at Beginning of Month	$ 0	$ (17,200)	$(16,540)	$ (8,920)	$ (3,400)	$ 4,220
Cash-Ins						
Sales Paid	0	30,000	35,000	35,000	35,000	35,000
Loans and Transfers	15,000	0	0	0	0	0
Total Cash-Ins	15,000	12,800	18,460	26,080	31,600	39,220
Cash-Outs						
Start-Up Costs	28,200	0	0	0	0	0
Books & Other Products	0	14,640	17,080	17,080	17,080	17,080
Rent	3,500	4,500	4,500	4,500	4,500	4,500
Salaries	0	2,500	2,500	2,500	2,500	2,500
Utilities	0	250	250	250	250	250
Telephone	0	250	250	250	250	250
Office Equipment	0	1,400	0	2,100	0	0
Insurance	0	3,000	0	0	0	0
Advertising	0	700	700	700	700	700
Accounting	0	300	300	300	300	300
Electronic Payment System Fees	0	300	300	300	300	300
Loan Payments	0	500	500	500	500	500
Miscellaneous	500	1,000	1,000	1,000	1,000	1,000
Total Cash-Outs	32,200	29,340	27,380	29,480	27,380	27,380
Cash at End of Month	$ (17,200)	$ (16,540)	$ (8,920)	$ (3,400)	$ 4,220	$ 11,840

June	July	Aug	Sept	Oct	Nov	Dec
$ 11,840	$ 17,360	$ 21,980	$ 29,600	$ 34,420	$ 42,040	$ 49,660
35,000	35,000	35,000	35,000	35,000	35,000	40,000
0	0	0	0	0	0	0
46,840	52,360	56,980	64,600	69,420	77,040	89,660
0	0	0	0	0	0	0
17,080	17,080	17,080	17,080	17,080	17,080	19,520
4,500	4,500	4,500	4,500	4,500	4,500	4,500
2,500	2,500	2,500	2,500	2,500	2,500	2,500
250	250	250	250	250	250	250
250	250	250	250	250	250	250
2,100	0	0	2,800	0	0	0
0	3,000	0	0	0	0	0
700	700	700	700	700	700	700
300	300	300	300	300	300	300
300	300	300	300	300	300	300
500	500	500	500	500	500	500
1,000	1,000	1,000	1,000	1,000	1,000	1,000
29,480	30,380	27,380	30,180	27,380	27,380	29,820
$ 17,360	$ 21,980	$ 29,600	$ 34,420	$ 42,040	$ 49,660	$ 59,840

EXAMPLE: Inga completes her cash flow projection for her first year in business, as shown above. She starts her projection one month early to account for the money she must spend before she opens her bookstore. In her cash-in section, she figures in $15,000 that she will put into the business: $10,000 of her own savings and an interest-free loan from her sister of $5,000. In her cash-out section, she includes what she'll pay for the initial set-up of the business, as well as that month's rent and a $500 allowance for unexpected expenses. Inga also includes in her cash-out section a $500 payment each month to her sister for the loan.

Notice that Inga's cash-outs look a bit different from her expenses in her profit/loss forecast, even though they add up to the same totals. There are a few reasons for this. One is that Inga includes her inventory costs in the cash-outs section, instead of accounting for those costs in the gross profit calculation, as in her profit/loss forecast. Also, Inga's cash-outs section of the cash flow projection reflects that some expenses are not paid equally every month. For instance, her insurance is paid twice a year, and she plans to buy office equipment in a few chunks.

Also notice that Inga's estimated paid sales (as opposed to sales on credit) for the year come to the same total as her estimated annual sales revenue. That's because, for her first year, at least, Inga doesn't plan to take credit cards or checks, only cash and ATM purchases. That way all her sales will be paid immediately.

Inga's happy to see that by the end of April she should have cash left in the bank after all her expenses are paid (though she hasn't yet provided for money for her living expenses). Still, she needs to close the cash deficits that she predicts for her first three months in business. Based on her cash flow projection, an extra $17,200 up front would keep her cash flow (barely) in the black. She decides to apply for a loan of $15,000 and try to juggle expenses to cover the remaining $2,200 shortfall.

Once you've completed a year's worth (or more, if you want) of a cash flow projection, you'll have a blueprint for your business's financial situation from month to month. If any months are projected to have a cash deficit, you'll need to tweak your plan to make sure you can cover all of your important expenses. As usual, this means you'll have to juggle, reduce, or cut costs. A cash flow projection that shows difficulty in paying all your bills won't only scare investors away; it might mean that your plan needs serious revision. On the other hand, if your cash flow projection shows that you'll be in the black every month, then you'll be in a good position to show your numbers to potential sources of money—and to get your business underway.



CAUTION

Credit transactions complicate the picture. Cash flow analysis is concerned with when your business receives or spends money, not when sales or purchases are made. This means that you'll need to account for delayed payments if you do any sales or purchases on credit.

Putting It All Together

Congratulations! You've finished the descriptive and financial aspects of your business plan. While you kick back and enjoy a cold one, think about how you want to put all the information together. If you put the plan together for your own information, then you might want to simply review it, edit anything that needs fixing, print it out, and put it into a binder for your reference. If you plan to present the information as part of a loan request or as a package for investors to review, you might want to do some extra polishing (consider hiring a writer to help develop the information into a well-written, persuasive document). The bottom line is to package the information as needed for your specific purposes. One of those purposes might be to raise start-up money.

Chapter 4 Checklist: Drafting an Effective Business Plan

- ☐ Decide how you will use your business plan: to attract investors or for your own use as a blueprint for your business.
- ☐ Draft narrative sections of your business plan that describe your business in detail.
- ☐ Put together financial projections for your business, including a break-even analysis, a profit/loss forecast, and a cash flow projection.
- ☐ Have a friend or business associate look over your plan—both the descriptive elements and the financial analysis—and make edits or suggestions.
- ☐ Edit your plan and prepare a final draft. Assemble the various sections of the plan into a final document, and package it as necessary for how you intend to use the plan.

CHAPTER

5

Raising Start-Up Money

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A great idea and a thorough plan sometimes aren't enough to get a business off the ground; some businesses need start-up funds. This chapter addresses what to do if you need an infusion of cash to move from planning to launch.

Plenty of businesses cost practically nothing to start, especially if you already have a computer or the tools for the business you're starting. Consultants, freelancers, and creatives of all types typically already have the minimum equipment they need to get started. Other businesses like restaurants, retail stores, or manufacturers will need a moderate to significant amount of cash to get operations rolling.

If yours is a business that will require some capital to launch, your first order of business is to do the financial analysis and business planning discussed in the previous chapter. Having a solid business plan in place is a must if you plan to seek start-up funds. Before you start your quest for cash, however, you'll also need to understand the types and sources of financing generally available to start-up businesses. Further, it's important to be realistic about your business's prospects for raising funds and the impact that a loan or an equity investment can have on the business—and on your life. (Spoiler: Money from investors, and to a lesser degree, lenders, can seriously spike the pressure on a startup's owners.)

This chapter provides an overview of what you need to know about small business financing, common sources of start-up funds to consider, and how to develop a realistic plan to obtain the start-up funding you'll need.

Realities of Funding a Start-Up

Business media, incubators, schools, and others tend to emphasize "getting your business funded" as the presumed goal for start-up businesses. Yes, it's critical for capital-intensive businesses like tech start-ups to find outside funding. But most start-ups aren't tech companies, don't need venture capital funding, and aren't driving toward an IPO. Indeed, only 1–3% of new businesses obtain funding from venture capital firms.

When I use the term "start-up," I'm talking about any new business, not just the 1% that launch with venture financing. I'll give the basics on how venture financing works in this chapter, but my focus will be on the best funding strategies for the other 99% of us.

With that in mind, let's look at some other hard realities regarding funding for a start-up:

- **First.** It's much harder for start-up businesses to secure *any* kind of financing—whether debt or equity financing (details on each below)—than for existing businesses. The simple reason is that start-ups lack a history of success or creditworthiness. If you have a history of making money with one or more previous ventures, that can help a lot. On the other hand, if you have no experience in starting or running a small business, your plea for funds will be an especially hard sell.
- **Second.** If you do have plans to court investors in your business, in exchange for a share of equity in your company (this is called "equity financing"), you need to know that professional investors (those outside your circle of family or friends) are laser-focused on whether they are likely to increase their investment severalfold in a relatively short amount of time (the shorter, the better, in their view). Because investors know that not every business succeeds, they need their "winner" businesses to yield high profits. Unless you have a personal relationship with an investor, you should expect them to make a purely money-motivated decision about funding your start-up. No amount of passion or personal story or creativity or charisma will convince a professional investor to just "give you a chance." It's all about the numbers (although the investor needs to believe in you, not just in the numbers).
- **Third.** Think hard about what your day-to-day vision of your business is, and how much you are comfortable with starting a business that needs start-up capital at a level that requires lenders or investors. If you really believe in your business idea, and have done detailed planning and analysis that show a high potential for success, and you're able to convince lenders or investors of the financial opportunity, then it might make sense to take on outside financing. In doing so, you might be taking on more risk and more stress than if you opted for a scaled-down version of your business that has lower capital needs. It's up to you whether the rewards would be worth the extra risk and stress.

The bottom line is that starting a business with financing from loans or investors requires careful planning and a high level of commitment to the business. If you're not sure whether you are ready for that level of commitment, start-up loans or equity financing might not be the right path for you. Instead, consider starting small, bootstrapping, and growing your business slowly.

If, on the other hand, you want to pursue outside financing, your chances of successfully raising start-up money will be improved by understanding some basics about how financing works and by knowing where to look (including non-traditional funding sources).

Entrepreneur's Insight

Ruth E. Dove, cofounder of Coffee + Creatives, a networking group for creative entrepreneurs

Sometimes starting a business feels like such a slow process, and the beginning so informal, that lining up the business and money-related processes can feel like a task that can wait until the business is more established. However, the sooner an entrepreneur formalizes these necessary systems, the less likely one is to run into complicated and time-consuming tax, banking, and other financial issues. The fulcrum of wanting to run a business is to have control over a revenue stream. Treat money with the respect it deserves as an integral part of the business, and it will work for you, instead of you working for it and having to spend more of it on making up for not starting on the right foot.

Debt Versus Equity Financing

An initial, fundamental distinction to understand is the difference between debt financing and equity financing. It's simple and straightforward: With debt financing, you borrow money that needs to be repaid; equity financing involves receiving money in exchange for an ownership share in your business (known as equity). We'll dig in a bit more later in this chapter, but for now just recognize this fundamental difference.

Note that lenders and equity investors can be people you know, such as family, friends, or business associates, or they could be banks, incubators, or venture capital firms (though as noted above, venture-funded start-ups are *far* rarer than is generally assumed).

Unless you originally planned to get money by acquiring equity investors, chances are that a business loan is a more practical option for your business. Besides the fact that only the smallest percentage of businesses meet equity investors' criteria, equity financing also presents potentially complicated legal and structural issues. Plus, it will dilute the shares that you and any other original founders of the company own. This means your share of business profits will be reduced.

Start-Up Funding Stats

A fact that surprises many entrepreneurs is that the most popular source of start-up funding is the source closest to home: personal savings. Surveys of business owners consistently show that most of them use their own money to start their ventures. According to a 2014 survey conducted by Gallup and Wells Fargo, 82% of entrepreneurs reported their ventures were self-funded, while just 1% reported using venture capital. Only 3% reported using crowdfunding. Smaller studies done since 2014 reflect largely the same breakdown.

Self-Funded	82%
Loans	41%
Lines of Credit	41%
Friends & Family	24%
Crowdfunding	3%
Venture Capital	1%

Source: Wells Fargo/Gallup Small Business Index, Q2 2014.

You might also need to share management control and decision-making authority with your investors. Be sure you understand how involved an investor wants to be in your business, and only take the investment if you're comfortable with that level of involvement. A passive investor fits easily into a business ownership structure as a shareholder in a corporation, a non-manager member in a manager-managed LLC, or a limited partner in a limited partnership. (Limited partnerships are a poor fit for most businesses because they don't provide limited liability for the general partners.) A shareholder in a corporation or non-managing member in an LLC has voting rights—either directly, as in the right to vote on certain matters, or indirectly, as in the right to elect corporate directors or LLC managers (who then make management decisions) to the board of directors. To avoid confusion and conflict, make sure those rights are agreed upon and clearly spelled out in a corporate shareholder agreement or LLC operating agreement. In general, equity financing involves more structural complexities than raising money via a loan.

Business Loans

Business loans have traditionally come from banks, but alternatives to commercial banks have emerged. We cover some of those alternatives below. (Loans can also come from family and friends, but for the purposes of this section, let's focus on loans from financial institutions.)

Commercial Loan Basics

Loans can be secured or unsecured. When you obtain a secured loan, you give the creditor an interest in some kind of asset—such as business equipment, real estate, inventory, or receivables—in case you default on the loan. An asset used to secure a loan is called collateral. Lenders tend to be conservative when appraising the value of the collateral, and they will lend only a percentage of that value. The loan amount compared to the value of the collateral is called a loan-to-value ratio. An unsecured loan is a loan that is not backed by any collateral.

Because a strong credit history or established cash flow is essential in obtaining an unsecured loan, most start-ups aren't in a good position to obtain one. Also, banks usually require start-up business owners to personally guarantee the loan, which puts your personal assets at risk—even if you are incorporated or have formed an LLC. A personal guarantee can sometimes be avoided if you put up sufficient collateral, but personal guarantees are a necessity for most loans to start-up businesses.

What Happens If I Default on a Loan?

A few things can happen when a business defaults on a loan. If the loan was secured by collateral, the creditor/lender can take possession of that property, often without even having to go to court. In this case it's important that the secured property and the lender's security interest are clearly stated in the loan document.

If the loan was unsecured, creditors can sue the business to collect. If the creditors win in court, they can garnish the business's bank accounts or place liens on property owned by the business. If you didn't create an LLC or a corporation as your business structure, or if you personally guaranteed the loan, then your personal assets are at risk, as well. (More on this below.)

Regardless of what property can be taken to satisfy your debt, you can pretty much count on some harsh effects on your credit rating, which typically results in getting socked with higher interest rates for everything from credit cards to mortgages, because you'll be deemed a higher-risk borrower. Sometimes only your business's credit rating will be affected, but your personal credit rating can suffer as well.

Certain details regarding your loan are obviously crucial, such as the length of time over which you'll pay it off (the term), the interest rate, and any fees you'll need to pay. Most small business loans are short term, from one to three years. As with most other loans, the longer the loan, the higher the interest rate. Interest rates can be variable or fixed, usually a little higher for a fixed rate. In addition, you might have to pay points or other fees for various aspects of the application process, such as document reviews or credit checks. Find out if the lender imposes any fees for prepayment of the loan.

Traditional Business Loans and SBA 7(a) Loans

Most commercial banks won't lend to a small business in its first year or more of operation—until the business establishes a track record of generating revenue or has built up assets that can be collateralized. Even then, many commercial banks will lend to a small business only if the loan is backed by the Small Business Administration. Such loans are typically referred to as "SBA loans."

The SBA does not provide loans itself, but it helps businesses secure loans from banks by guaranteeing them—in other words, the SBA promises to repay the loan (up to a certain limit) if the business defaults. As with traditional bank loans, you'll often need collateral or a personal guarantee for an SBA loan.

The most common form of SBA loan is a 7(a) loan. The 7(a) Loan Program is the SBA's primary business loan program, and the funds from a 7(a) loan can be used for working capital and to acquire equipment, real estate, and other business assets. But you must have an operating business to qualify, meaning that 7(a) loans are not generally available to start-ups.

Learn more about SBA loan programs and other assistance for small businesses at www.sba.gov.

Working With Locally-Owned Banks and Credit Unions

Unlike big commercial banks, locally owned banks tend to be more invested in supporting local businesses and community economic development. Instead of strictly relying on credit reports and collateral, local banks may use broader criteria, or a "character-based lending" approach. Credit unions are often similarly oriented; they differ from commercial banks in that they are nonprofit entities. Because they are not beholden to shareholders, credit unions are freer to base lending decisions on community and character values, not just profit.

Community-Based Lenders: CDFIs and SBA Microloans

Thankfully, you have alternatives to commercial banks as you seek a loan for your start-up. Through programs under the SBA, the U.S. Treasury, and other agencies, there is a robust national network of community-oriented funding sources and organizations designed to help small businesses access the capital they need. Connecting with these organizations can be a game changer, as they go beyond basic lending services by providing support and expertise to nurture your fledgling business.

The ecosystem of funding sources and organizations that manage them is complex, but we highlight two such sources below: community development financial institutions (CDFIs) and SBA microlenders.

- **Community Development Financial Institutions (CDFIs)** provide credit and financial services to businesses in economically distressed areas. If your business will operate in a low-income community and would contribute to economic development of the community, you might be a candidate for CDFI funding. CDFIs are certified by the U.S. Treasury Department CDFI Fund, and they include community development banks, community development credit unions, community development loan funds, and community development venture capital funds.
- **Microlenders** are nonprofit community-based organizations that manage loans up to $50,000 under the SBA's Microloan program. Because these loans are typically bundled with guidance and expertise, they can be especially helpful to start-ups. For more information on the SBA's Microloan Program, visit www.sba.gov/funding-programs/loans/microloans.

Since these community-based lenders are integrated with community economic development programs aimed at building thriving communities, they might offer a better chance of accessing the start-up funds you need than commercial banks would. And you might find them easier to work with than commercial banks. For example, if your business idea has flaws or your business plan needs development, there's a good chance that a community-based lending institution will work with you to tweak your idea or plan so that it does qualify for a loan. Many offer classes and workshops that guide you through the business planning process, with the goal of completing a business plan. They may provide additional support through one-on-one consulting, providing feedback to your business plan drafts.



RESOURCE

For help in finding a CDFI. To find a certified CDFI in your area, go to the CDFI Fund website at www.cdfifund.gov.

Lines of Credit

Once you're up and running, a revolving line of credit from the bank can help you to manage your cash flow. A line of credit works on the same principle as a credit card, but generally offers better terms than credit card cash advances. The business can borrow funds up to the credit line limit on an as-needed basis and has to pay interest only on the outstanding balance (not the entire credit line). The business can choose to pay funds back and reborrow them as necessary during the time the credit line is open. Credit lines can be open for a specified period, such as five or ten years, or can be open-ended (like a credit card).

Equity Investments

A person or business (including people you bring on as partners) that gives your business money in exchange for an ownership share could be called an "equity investor." For the purposes of this section, what I mean by an "equity investor" is someone outside your company, not an original founder, whom you approach in your search for funds. I'm also not talking about family or friends here, but they certainly can be equity investors; I talk about raising money from family and friends later in this chapter.

Equity investments can come from investors who work in venture capital firms, or individuals often known as "angel investors." What all types of professional investors have in common is that they will be motivated by making a hefty return on their investment in as short a time frame as possible. While typical rates of return that investors want or expect varies by industry and economic conditions, the National Venture Capital Association says the average early-stage (start-up phase) equity investor seeks a tenfold return on their investment within eight years.

Professional investors tend to have specific interests such as biotech, sports, manufacturing or other niche specialties. If you plan to seek equity financing you'll need to research which firms or angel investors are active in your field.

Venture capital firms and angel investors typically have strict formulas for what they will invest in. In all fairness, being strict this way is usually critical to their overall success in making money. If professional investors gave money to every enterprise that piqued their curiosity, even in the absence of a compelling business

plan predicting rapid growth and profits, they would burn through an awful lot of money—which could easily cut short their careers as investors. There's no quicker way to ending a career as an investor than running out of funds.

What Happens If My Business Fails and I Have Equity Investors?

Equity investors balance the risk of the business failing with the possible reward of being a part owner of a successful, profitable company. Unlike a business loan situation, you don't typically have an obligation to pay an equity investor back if the business fails. If the business fails, everyone's shares are worthless, including the investor's shares.

Note, however, that the legal documents between the company and the investor will determine the terms, and some investors try to include provisions that protect them in case the business fails. It's not uncommon for investors to insist on having rights to claim money left in bank accounts, accounts receivable, proceeds of assets sold, or intellectual property of a company that fails.

As you can see, the details of your agreement with an equity investor can be extremely important. While this book advises a DIY approach for many business start-up tasks, executing an agreement with an equity investor is a transaction that calls for professional guidance.

According to conventional wisdom (and all the grains of salt that go with that), investors expect 30–40% of start-ups to fail to return any of their investment, 30–40% to return the original investment, and 10–20% to produce substantial returns.

Because of this, investors are always biased towards growth-oriented companies that can "scale" quickly and efficiently (in the context of business, to "scale" means to grow *extremely* fast). These are the firms that carry the load for all the losers—and there are always losers.

Have I mentioned that venture-backed firms represent less than 1% of startups overall? I repeat this because there's such a disproportionate amount of information and resources on this topic, leading to a radically skewed image of venture capital being an important part of entrepreneurship. For 99% of new businesses, it is no factor at all.

What Lenders and Investors Look For

In addition to making sure you have a solid business plan that shows your business idea to be a winning one, a bank or institution considering funding your business (whether through debt or equity financing) will want to know other details of your current and prospective financial situation. The more you can present a convincing picture of your venture's

sunny financial prospects, the higher your chances of success. Part of the trick is understanding what lenders and investors are looking for and getting into their mind frame.

In the most general terms, lenders are focused on whether or not you can repay the loan within the time frame specified in the loan terms. If the loan is secured with collateral, the lender is generally more willing to approve the loan, because they have more of a guarantee of being repaid. With unsecured loans, the lender will be more interested in whether your business plan looks solid and likely to succeed. If your plan is sketchy or reads like a pipe dream, you won't be likely to be approved for a loan (which might be a blessing if your business idea wasn't solid after all).

As stated above, equity investors are concerned with whether your business plan looks likely to yield rapid growth and profits in a short amount of time.

Once your business is underway, you might want additional funding for growth or expansion. Lenders are particularly interested in certain measures of existing businesses to determine whether an expansion loan is a worthy credit risk. One such measure is your business's balance between debt and equity—a relationship that is called a debt-to-equity ratio. Your debt-to-equity ratio is the extent to which your business is in debt to lenders, versus how much you and any other owners have invested in the business. The ratio is calculated simply by dividing outstanding debt by the owners' equity in the business.

EXAMPLE: Sara is considering financing options for her sole proprietorship, which has been in operation for about two years. So far, she has invested $50,000 of her own money into the business and obtained one loan for $15,000, of which she has paid back $5,000. Her debt-to-equity ratio is calculated as follows:

Outstanding debt	$10,000
÷ Owner's equity	$50,000
= Debt-to-equity ratio	20%

In the most basic terms, lenders want to see a low ratio of debt to equity to make sure your business is not overextended and has sufficient assets to repay the loan. Commercially acceptable debt-to-equity ratios generally range from 50% to 150%—but because ratios over 100% reflect more debt than equity, they should be viewed with caution. Conversely, if you have nearly no debt, lenders might take it as an indication that your business is not leveraging its assets to make the most of business opportunities.

Of course, when you're seeking a loan for the first time, your debt-to-equity ratio will be zero. The point is to understand the ratio and how lenders view it so that you can keep it in the right range as your business grows.



TIP

Establish a relationship with a bank. It's smart to establish a relationship with a bank early in the life of your business, even if you don't need start-up funding. Open an account and use the services it offers to small businesses to establish your business as a trustworthy and reputable customer. With a solid relationship in place, you'll be in a better position to apply for funding down the road—say, via a loan or a line of credit—when your business is growing and needs money to expand.

Alternatives to Institutional Funders

If a bank, a microlender or CDFI, or an equity investor isn't your speed, you have a few more options. Here's an overview.

Family and Friends

Because start-ups are so commonly turned down by banks and other traditional funders, entrepreneurs often turn to friends and family for an injection of cash. But as you surely know, you must be careful when mixing money, blood, and friendship. Things might turn out great, but friends and family funders should be prepared for one of two unpleasant outcomes: losing the money but keeping the relationship, or taking steps to be repaid at the expense of the relationship. The best way to proceed is to be as businesslike as possible when getting money from family or friends. If the funding is in the form of a loan, draft a promissory note outlining the amount of the loan, the interest rate, and its repayment terms. Make it clear to the person who is lending you the money that you will treat the loan just like a commercial loan from a bank. And follow through with that promise by generating financial reports at least quarterly— and paying back the loan according to the agreed-upon terms.

If the family member or friend is providing an equity investment, be clear with the investor what rights they'll have as a shareholder or LLC member and what your plan is to return their money over time. Perhaps they'll want to leave the money in the business and participate in the company's (and their stock's) growing value and any corporate dividends or LLC distributions. Or, they might expect a return of capital in a given timeframe. Try to determine the investor's expectations and then to reflect those expectations in your financial plan (such as by building in a stock buyout in Year 5).

Credit Cards and Home Equity Loans

If all other options have failed, many tenacious entrepreneurs turn to credit cards and home equity loans to get their ventures off the ground. This route could work, but you must watch for serious potential pitfalls. Credit cards often charge much higher interest rates than business loans. If you keep high balances on the credit cards and make just the minimum payments, your debt can quickly spiral out of control and take decades to pay off.

Business owners who resort to credit cards to finance the business might not be as disciplined in managing the debt and spending as their counterparts who are under scrutiny from a lender. While bank lenders typically require financial reports and other proof of solid financial management, credit cards do not—potentially allowing you to get sloppy with your finances. Don't make this mistake. If you use credit cards as start-up funding, be just as serious about your bookkeeping and financial management as if you had a big bank looking over your shoulder.

Home equity loans will usually offer better interest rates than credit cards, but of course, they require you to put your home at risk. If your business fails and you are unable to pay your home loan, you could face foreclosure. Be sure you evaluate this sobering possibility before taking out a loan against your home to finance your new business.

Crowdfunding and Social Media

Crowdfunding refers to a method of raising money online that harnesses the power of social media to spread the word about your business or project.

Crowdfunding sites are social media sites that are geared towards enabling users to raise money for various types of projects from other folks online (more on that in a moment).

To raise money through crowdfunding, you typically choose a crowdfunding platform (such as one of those mentioned below), create a campaign with information about your project and why it needs funding, set a dollar amount goal and a deadline, and promote your campaign using social media, such as Facebook, X (formerly Twitter), or Instagram. You can also spread the word about your campaign using good old email. The crowdfunding platform will typically keep 5-10% of the funding raised.

Many crowdfunding campaigns offer rewards, which might include the actual products (or sometimes services) you're aiming to sell. When you offer the products themselves as a reward, the crowdfunding campaign essentially becomes a preorder system and can be really effective. Of course, if you offer a reward for contributing, it's essential you follow through and provide the reward in a timely manner.

Kickstarter (www.kickstarter.com) and Indiegogo (www.indiegogo.com) are two of the leading crowdfunding platforms for start-ups.

When choosing which crowdfunding platform to use, besides knowing which types of projects each will handle, be sure you understand whether the site is an "all-or-nothing" model or a "keep what you raise" model. For example, Kickstarter uses an all-or-nothing model, so if you don't meet your fundraising goal by the deadline, your backers don't pay and you don't get anything. Indiegogo, on the other hand, offers a "flexible funding" option that allows you to keep what you raise, even if you fall short of your fundraising goal. Whether or not you meet your goal, you'll be charged a 5% fee of the total raised.

Crowdfunding typically works best for businesses and people who already have a strong social media presence, or at a minimum the skills and resources to tackle online marketing effectively. If your business (or an embryonic version of it) has hundreds or thousands of followers on Facebook and interacts with them daily, you'll likely get a lot of mileage from a crowdfunding campaign that you promote appropriately on Facebook. If, on the other hand, your business rarely uses social media, it will be harder to get traction with a crowdfunding campaign, even one that's well-crafted and compelling.

Here are some general tips for using social media to raise money for your start-up:

- **Use social media in combination with other traditional outreach tools.** Social media is great for spreading the word about offline events or sharing links to press coverage or other information (for details, see Chapter 14). When used as a component of a multichannel promotional push (which could include a crowdfunding campaign), social media can dramatically expand the reach and exposure of your message.
- **What's hot might not be effective, and what's effective one day could be old news the next.** Kickstarter and Indiegogo are hot crowdfunding options today, but in a year or two they might fall out of favor. The lesson is that you have to constantly stay on the lookout for what's new, innovative, and effective in social media crowdfunding, and be ready to switch course if your methods become outdated.

- **Crowdfunding fatigue is real.** While crowdfunding can absolutely be an effective way to raise funds from your supporters, it is also a bit of a victim of its own success. Social media is so full of appeals for money—many of them extremely worthy—that the public is beginning to tune out. People who jumped on board just a couple years ago, with their credit cards ready, now are weary of being asked for funds every time they check Facebook. Your potential donors' crowdfunding fatigue means that your appeal will need to be particularly well-presented. Don't be discouraged if you fail to meet your goal.
- **As with networking in the real world, the payoff from networking online isn't usually immediate or direct.** Keep a broad, long-term perspective when engaging in social media. Networking isn't the same as direct solicitation, and you shouldn't expect every "friend" to rain funds on your project. But over time, the exposure, relationships, and goodwill you generate through your social media efforts will undoubtedly pay off in some measure.

Chapter 5 Checklist: Raising Start-Up Money

- ☐ Learn about debt and equity financing so you can develop a realistic vision of how each works and how that kind of funding might affect your business.
- ☐ Consider the realities of taking on debt or equity investors, and whether they are compatible with your vision of running your business at a scale you are comfortable with.
- ☐ If you decide to pursue either debt or equity financing from banks, micro-lenders, CDFIs, venture firms, or angel investors, make sure your business plan is thorough and polished.
- ☐ If you ask family or friends for money to start your business, treat the transaction professionally and put your terms in writing.
- ☐ If you are savvy at marketing or communications online, consider crowdfunding, which can be structured as presales of your product or service.

CHAPTER

6

Pricing, Bidding, and Billing Projects

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Pricing is a crucial factor in any business strategy, yet many fledgling business owners have little idea how to go about setting prices that are both competitive and profitable. This chapter explains how to develop your pricing strategy and introduces you to some standard methods for setting prices, whether your business sells services or products.

In addition, this chapter offers guidance for business owners who need to make bids to get work. Service businesses typically fall into this category, though sometimes product-based businesses also need to bid for jobs. This chapter also includes some general tips for the process and an outline for what typical proposals include.

On a cautionary note, be aware that antitrust laws forbid business competitors to fix, and even merely discuss, prices. For this reason, you won't find newsgroups or bulletin boards online where other businesses in a certain industry offer specific info on their pricing. Both online and off, pricing discussions among businesses in the same industry are not just taboo; they're illegal.



SKIP AHEAD

Product sellers can skip ahead. Business owners who plan to sell only products don't need to deal with service-pricing or service-billing issues. If you don't plan to offer services, skip ahead to "Pricing for Businesses Selling Products."

Directly sharing pricing info with competitors is illegal, but publishing general information about pricing guidelines is not. Good thing, because pricing is discussed first in this chapter.

Pricing and Billing for Service Businesses

Two major components of running a service-based business are setting prices and figuring out how to bill clients. Having rates that are well thought out is a key factor in soliciting clients confidently. And if you know the best way to bill them, you can manage your projects for maximum profitability and establish yourself as a true professional. This section explains these two essential tasks for service businesses. Once you understand what drives the pricing and billing processes, you'll find them much easier.

Setting Hourly Rates

Those who work as freelancers or own service-based businesses often find it difficult to figure out what rates to use. Many people struggle with assigning value to their time, especially when they're new to self-employment and lack confidence. So part of the challenge can be getting over a mental hang-up, and developing confidence in the fact that your work has

value. Another important fact to remember is that your rates need to cover more than just the value of your time—they also need to cover your overhead and yield your profits.

There's no single formula to put a price on your services, but learning about two common approaches is a good place to start. One is based on adjusting the number of billable hours so that revenue equals salary, overhead, and profit. Another approach bases hourly rates on what the market will bear. Many, if not most, businesses use a combination of these approaches, each of which is described in more detail below.

Billable Hours Formula

This straightforward formula calculates an hourly rate based on what fixed expenses you need to cover, and how much salary and profit you want. To keep it simple, start by considering this formula as if you're a solo freelancer without employees:

	Desired annual salary
+	Annual fixed costs (or overhead)
+	Desired annual profit
÷	Annual billable hours
=	Hourly rate

The gist of the formula is that it adds together all the money you want to bring in each year and divides that total by the number of hours you plan to work each year. The result is the hourly rate. This simple formula can be adjusted according to the specifics of your business.

But first, it's a good idea to get a solid grasp on the concepts behind the formula:

- **Desired salary.** This is straightforward. How much would you like to earn annually? Include only salary here; desired profit comes later.
- **Fixed costs.** This is also a simple concept. How much will you spend each year on rent, utilities, office equipment, computers, and other items of overhead? As discussed in Chapter 4, fixed costs are independent of individual projects or services. They more or less stay the same regardless of how much (or little) business you're doing.
- **Desired profit.** You're in business to make a profit, not just to bring home a paycheck. A typical profit goal is 20% above salary and overhead (all of which are fixed costs).
- **Billable hours.** Basically, the fewer billable hours you estimate, the higher your hourly rate will be; the more billable hours, the lower your hourly rate. A common way to approach this estimate is to start with the number of potential billable hours in a year. With 52 weeks in the year and a 40-hour workweek, there are 2,080 potentially billable hours each year. Reduce that total by the number of nonbillable

hours you expect to have—vacation, administrative work, or selling, for example. Just use your best estimate here. Very generally, the percentage of your time that is billable will probably be 50% to 80% of 2,080. Much below that won't be very profitable, and higher than that usually isn't realistic. Use this percentage to determine how many billable hours you'll likely have each year. For instance, if 70% of your time will be billable, you will have 1,456 billable hours (2,080 hours × 70%).

Now add together your desired salary, fixed costs, and desired profit. Then divide that total by your billable hours. The result will be the hourly rate you'll need to charge to cover your fixed costs and bring in your desired salary and profit.

EXAMPLE: Samantha is starting a translation service and wants to figure out her hourly rate. She sets a first-year salary for herself of $30,000 per year and estimates her annual fixed costs to be approximately $12,000. This totals $42,000 for salary and overhead. A 20% profit brings the total to $50,400. Samantha thinks she'll have to spend a good amount of time doing sales and getting her business off the ground, so she figures only about 60% of her time will be billable, resulting in 1,248 available billable hours. By dividing her salary, fixed expenses, and profit ($50,400) by 1,248 billable hours, Samantha sees that her hourly rate should be $40.38. She rounds that up to $45 per hour.

	Salary	$ 30,000.00
+	Fixed costs	12,000.00
	Total salary & fixed costs	42,000.00
+	20% profit	8,400.00
	Total salary, fixed costs & profit	$ 50,400.00
÷	Billable hours	1,248.00
=	Hourly rate	$ 40.38

Market-Based Rates

Another way to figure out your hourly rate is to consider what the market will bear, and set it in relation to your competitors. If other photographers charge between $100 and $250 per hour, you'd evaluate where you fall in that range in terms of your experience, the level of service you want to provide, and any other factors that would justify your rate being higher or lower within the spectrum of what's typical in your market.

The main hazard of this approach is that it might not yield a profitable hourly rate, because you're not basing your rate on the actual numbers you'll need to achieve. If you have significant overhead—say, expensive rent, or an assistant on your payroll—it's not wise to rely exclusively on this approach. (Below we discuss how to use this in tandem with the billable hours formula.) On the other hand, using your competitors' rates as a guide is smart in that it accounts for actual market conditions, so your rate might be more acceptable to clients.

If you base your rates on the market, use any market information you can get to guide you—including what competitors charge, industry standards, and your own experience of using various rates. If you constantly fail to snag clients once you provide a quote, that's a sign your rates may be too high. On the flip side, if you get every job you bid on, you could probably get away with nudging, or even shoving, your rates upward.

Use Both Approaches to Determine Your Rate

It's often a good idea to use a combination of the formula-based and market-based approaches. Using the formula will help ensure that you set a rate that is profitable, and using the market to adjust the rate up or down will help you stay competitive.

For example, if the formula yielded an hourly rate of $45, but other similar businesses charged $65 to $75 per hour, you could feel comfortable increasing your rate to $55 per hour, making your business a bargain while still turning a profit.



FORM

Billable Rate Worksheet. The Nolo website includes a downloadable interactive worksheet to help you calculate an hourly rate for your service business. See the Appendix for the link to this worksheet and other forms in this book.



TIP

It is legal to research and use competitors' rates. The antitrust laws mentioned earlier are intended to protect consumers by maintaining competition in the marketplace. The laws are supposed to prevent anticompetitive agreements among competitors to set prices at a certain level. On the other hand, setting your rates to position your business among similar businesses is perfectly legal, so long as you obtained your competitors' pricing information from another source, not directly from them. After all, researching the market and setting prices accordingly is the essence of competition.

Billing Options

Service businesses and freelancers typically use a variety of billing options to accommodate different types of projects and clients. Common billing options include flat fees, hourly billing, and retainer arrangements. Each of these options is discussed below.

Flat Fees

With flat fee billing, you and your client agree to a total fee for a specific project. In the right situations, it is efficient and professional to charge your client a flat fee for your services. The fee should roughly reflect the number of hours you'll work multiplied by your hourly rate. Contractors typically discount their hourly rates for larger projects.

Billing a flat rate per project usually makes clients happy because they know up front what their costs will be. Project-based billing can also benefit you. A flat fee encourages efficient project management and reduces the hassle of tracking and billing for your hours (though you should always keep track for your own records).

However, flat fees aren't the best idea for every project. You will feel underpaid if it takes much more work to finish a project than you expected, and the customer will feel overcharged if the project takes much less time than you estimated. If you want to bill flat rate, it's crucial that you and the client both understand and agree on the project's exact scope. In fact, this agreement should be reached even before you quote a fee. Once the client accepts your fee, the project details should be outlined in a contract. Payment terms can vary, but contractors typically require a deposit up to one-half of the total fee on signing the project contract.

Sometimes it's not possible to pin down a project with specificity at the outset. Some clients simply don't want to hammer out all the details. Other times, a short deadline makes it difficult or impossible to carefully consider all aspects of the project before you start work. In these cases, you're asking for trouble if you set a flat fee. Proceeding with hourly billing is much safer.

Suppose, for instance, that a client calls and needs a new section developed for a website ASAP. The owners of the site desperately want you to start immediately, but you have only a vague idea of the work involved. A flat fee here would be a really bad idea—the project could take much longer than you expect, leaving you to do the work for an unfairly low flat rate.

If the project isn't carefully outlined before you start, forget the flat fee—hourly billing is the safest way to go.

Hourly Billing

Billing clients by the hour is pretty straightforward. You keep track of how many hours you work, and bill the client accordingly. As explained above, you should use this type of billing—also called "time and materials billing"—in situations in which the project isn't well defined.

While billing by the hour will protect you from being underpaid for a poorly defined project that takes more time than you thought it would, the client will never be happy if you present a huge, unexpected bill. It's always a good idea to provide estimates at the outset, so you can be sure you and the client are on the same page. Even when you choose hourly billing for a project without a clear scope, do your best to work efficiently, communicate with the client, and avoid handing over a surprising bill.

Keep in mind that it is up to you to demonstrate your value to the client, explaining why your hourly rate is justified and how you spent your hours. Even if you can't define the project specifically enough to set a flat rate, do your best to estimate

how long the project will take, and try to keep your hours within your estimates.



TIP

Set reasonable hourly increments when billing. For instance, will you bill the client a full hour for work that takes you 20 minutes to finish, or for a five-minute phone conversation? Be careful or your client may see it as unfair. Many people use increments of 15 or 30 minutes for billing purposes. It can be good client relations to show some short phone calls on the bill with no charge attached. That makes the client feel better about the times you round up to the nearest 15 minutes for other tasks.

Entrepreneur's Insight

Jennifer F. Mahoney, owner of an illustration service in Northern California

It's helpful to learn about the accounts payable process for each client and to understand who in the company releases checks. It's often an entirely different person or department from the one who calls you to offer work. You don't necessarily want to strain your relationship with the person who calls offering you work just because a different department of the business doesn't pay on time. Pave the way for timely payments as much as possible by getting to know the correct procedure, and when it's time to press for payment, you'll know the right person to call.

Retainer Arrangements

In a traditional retainer arrangement, the client pays an ongoing fee, usually monthly, for the contractor to perform a defined set of services each month, or to keep the contractor "on call" for certain services. Retainer arrangements are usually best for clients with regular and predictable needs—for example, maintaining an accounting firm's website, providing maintenance services for an apartment building, or doing public relations for a ski resort. As with flat-rate billing, you should always define the amount and scope of services expected of you under a retainer arrangement.

In some professional businesses, especially law offices, a "retainer" is requested at the outset that is really a deposit, or a prepayment of fees and costs, usually under a written fee agreement. Lawyers also sometimes use the traditional monthly-fee retainer described above.

Bidding and Creating Proposals

Sometimes it's not possible to sell a service or product just by offering it to the public for a certain price. Many service businesses (and some businesses selling products) must submit a bid or a proposal on a project to be considered for the job. (The terms "bid" and "proposal" are often used

Charging for Outsourced Services

Sometimes a service business needs to hire another contractor (typically called a subcontractor) to get a job done for a client. You can charge your client for the subcontractor's work in different ways. You can simply charge your standard hourly rate for all work completed, whether your company did the work or a subcontractor did. This approach can work for or against you, depending on what you pay the subcontractor. Under a common second approach, businesses mark up the cost of the subcontractors and bill the client accordingly. Businesses vary a lot in how much they mark up subcontractors' rates. I've seen 10% markup and 100% markup. You'll have to decide what seems fair to your client and profitable to you.

Sometimes the client will hire and pay the sub directly, without a markup. This can work if that piece of the work is discrete, or distinct from the rest, and the client is responsible for supervising the sub's work and has appropriate liability insurance. However, many contractors prefer to choose and supervise all workers on the same project, for many reasons: They like to have total control over the project, they like to choose subcontractors whose work they trust, they usually make a fair profit on the subcontractor (using a markup), and it simplifies the project as well as the contractor's potential liability to the subcontractor and the client.

In any case, let your client know in advance whether you plan to use subcontractors on a project, especially if the subcontractor is a highly skilled specialist and the rate you bill for the subcontractor will be higher than your standard rate. Clients never like to be surprised with bills higher than they expected.

EXAMPLE: Glenn is a construction contractor with a standard hourly rate of $85 per hour. When hired for a remodeling project, Glenn tells his client he will need to hire a few subcontractors over the course of the project who might have rates higher or lower than his. Glenn and the client come to the understanding that they'll agree to all subcontractors and their rates before Glenn hires them. When it's nearly time to bring in a plumber, Glenn tells his client he'd like to hire Khalsa, whose rate to the client will be $105 per hour. Khalsa's own rate is $90 per hour, but Glenn marks up the rate by 15% and rounds up to $105 so that he can make a reasonable profit for managing Khalsa on the project.

interchangeably.) If the client accepts the bid, then a contract is typically prepared and signed to confirm the sale.

Because bids can make or break a sale, take care when putting one together, with both the contents of the bid and its production. Often, the hardest part of bidding is breaking down the project into smaller parts, so that you can make good estimates of how much work, time, and materials it will require. Once that's done, it is usually quite easy to write the proposal. This section outlines how to put together a bid to help ensure your chances of success.



SKIP AHEAD

When you don't need to get it in writing. Businesses selling products usually don't need to worry about bids or proposals. If you don't need to learn about the bidding process, skip ahead to "Pricing for Businesses Selling Products."



TIP

When a proposal becomes a contract. A proposal usually converts to a contract when a client accepts your terms. In practice, however, you should suggest that you sign a separate contract to finalize the agreement with the client. Doing so provides an opportunity to make sure the client truly understands what you said in your proposal. It's also a good idea because there are things you should cover in a contract that you wouldn't necessarily put in a proposal, such as who provides the insurance, how you will handle extras or change orders, specifics of each side's remedies for breach of contract, which state's laws apply, and whether you will mediate or arbitrate any disagreements. (See Chapter 11 for an in-depth look at how to use contracts in your business.)

Get All the Information You Need

You won't be able to make an effective bid on a project until you thoroughly understand all the details involved. Ask the prospective client as many questions as necessary to flesh out the full scope of the project. A prospective client who's putting a project out to bid typically issues a request for proposals (RFP), detailing the information the proposal must include and sometimes requiring a very detailed format. If you have questions, ask them.

Often, the client will want to be involved in certain aspects of the project, so it's important you both agree who will take a primary role in various tasks or duties. You should hash out the breakdown of duties and workflow right at the beginning.

Break Down the Project and Make Estimates

Next, break down the project into manageable components and estimate how much time, labor, and materials you'll need for each one. This is generally the best way to make accurate estimates.

For instance, your head will spin if you try to estimate how long it will take you to complete an entire landscape design project. But once you break the project into parts—grading, spreading gravel, paving, planting trees, and so on—making estimates for the individual bits won't seem nearly as overwhelming.

Multiply the number of hours you expect the project to require by your hourly rate. This will be the total fee for the project. It's common for freelancers to give a bit of a discount if the project is a large one. This is reasonable, because it's usually more profitable for a freelancer to work consistently on one project than to work piecemeal on several smaller projects.

Sometimes, however, freelancers are tempted to lower their estimates out of fear. After adding up all the hours needed for a large project and multiplying this by their normal hourly rate, they think the fee looks too high and start slashing it to make it more acceptable to the client. Guard against this temptation! It's fine to reduce your fee slightly when you anticipate efficiencies on a large-scale project, but don't sell yourself short just to get the job. Not only will you regret it after you've worked long hours on the project for an unreasonably low fee, but you'll fail to earn respect from clients if you don't ask for the compensation you are worth.

Consider Expenses

Who will be responsible for expenses incurred during the project? The answer varies from project to project. Typically, contractors are responsible for covering their own normal expenses of doing business. (However, this is not always true. Attorneys, for example, commonly bill clients for photocopying and mailing costs.) Clients usually bear any costs that aren't typical to the contractor's business, such as travel, international phone calls, or equipment rental fees.

You and the client should agree in advance who will cover which expenses. In addition, make sure to address whether you'll agree to limits on reimbursable expenses, or whether the client must approve expenses in advance. Also nail down how you will bill the client for expenses.

For example, travel expenses are quite often billed to clients. It's wise to make a specific breakdown of the expenses that will be covered, such as airfare, rental car, lodging, taxi, train, parking, and food.



TIP

Proposing reasonable limits on client expenses. Even when your client has deep pockets and seems willing to cover whatever expenses you incur, you should offer some limits on reimbursable expenses. This will help to head off potential conflicts or unpleasant surprises over reimbursement bills. It also shows the client that you care about giving a good deal.

You can handle payments for expenses a number of different ways. A few possibilities are discussed below:

- **Set an amount that the client will pay, regardless of the amount actually incurred.** For instance, you and the client can agree that the client will pay $1,000 to cover all travel costs. If your actual costs are lower, the extra money will be yours; if higher, you'll eat the difference.
- **Bill the client for actual expenses incurred.** You can do this with or without a cap. For instance, you could agree that the client will reimburse you for all actual travel costs. Or, you could agree the client will reimburse you for actual travel costs up to $500.
- **Set a per diem rate for certain expenses.** "Per diem" simply means "per day." Food is typically billed at a set per diem rate—say, $50 or $75 per day.

EXAMPLE: Samantha is working on a bid for a translation project that will require her to travel to Brazil. Her client, Bahia Travel Company, says it will cover travel expenses and asks Samantha to draft a proposal specifying the terms. Samantha drafts the following terms regarding travel expenses, which she will include in her proposal:

"Samantha will be responsible for all expenses involved in the project, except for travel-related expenses, which Samantha will bill to Bahia Travel Company monthly, as follows:

Airfare. Billed as actually accrued, including all taxes, not to exceed $1,500 per round-trip ticket. Tickets will be economy class.

Rental car. Billed as actually accrued, including insurance and taxes, not to exceed $50 per day for no more than five days.

Lodging. Billed as actually accrued, including all taxes, not to exceed $175 per night for no more than five days.

Food. Billed at $75 per day for no more than five days.

Taxi. Billed as actually accrued for no more than five days.

Parking. Billed as actually accrued for no more than five days."

Write Your Proposal

Once you've finalized the important details of the project, it's time to put together your proposal. Your goal is to present all important information clearly and to demonstrate you have a

solid plan for getting the job done right. Proposals should always be professional and somewhat formal in tone, but don't be afraid to let your personality show. If you feel stiff, you usually won't have a better bid, just a more stilted one.

Entrepreneur's Insight

Clare Zurawski, Grants Specialist and Management Adviser

A thorough, fair, and clearly presented proposal is a sure way to impress your would-be clients with professionalism, and paves the way for effective communication going forward.

Some project proposals are two to three pages long; some exceed 20 pages. The length of your proposal will vary according to the project. (You should, however, stick to the guidelines if you're responding to an RFP that specifies the length of the response.) Use as much space as it takes to outline the project details with adequate—but not excruciating—detail. An outline for a project proposal might go something like this:

- **Project overview.** Describe the big picture, including relevant details about the client and an overview of the project.
- **Project objectives and scope.** Offer detailed information about the project, including the different components of the project and how they fit together.
- **Proposed approach.** Describe how you would approach the project and how you would achieve the client's goals. Be specific, and don't assume that the client knows anything about how you do your work.
- **Specific responsibilities.** Outline what you understand your specific responsibilities would be.
- **Deliverables.** This is a term for the specific products that your work will yield. For instance, deliverables might include a 20-page written report, a set of tax documents, or a 100-page travel guide.
- **Timetable.** Scheduling is always an important part of project management, so you should always outline when you expect certain parts of the project will be completed.
- **Fee and payment terms.** In stating your fee, you don't have to explicitly state your hourly rate or how you arrived at your amount. Simply make it clear that your fee is based on your understanding of the project requirements as outlined in the rest of the proposal. It's also a good idea to mention that work beyond the scope described in the proposal will be quoted and billed separately.
- **Expenses.** Outline whatever agreement you and the potential client have regarding who will cover which expenses.

- **Conclusion.** Wrap up the proposal. Strive for a professional tone that expresses your enthusiasm for the project. Though some proposals serve as the project contract once the client has accepted them, you will usually say here that you expect to sign a separate formal contract.

Pricing for Businesses Selling Products

As with pricing services, you can use different ways to figure out what to charge for the products your business sells. Of course, your cost of acquiring or making the products will play a big part in your pricing decisions. But you might have difficulty deciding on an appropriate markup. This section will walk you through a few issues to consider when pricing goods.



CAUTION

Don't discuss your product pricing strategy with competitors. Antitrust laws forbid you to fix prices with your competitors and even to share price information or discuss prices with them. Steer clear of this potentially serious legal trouble by simply avoiding pricing discussions altogether.

Establish an Overall Pricing Strategy

Before deciding how much you'll charge for your widgets, you should think about and adopt an overall pricing strategy for your business. Keep in mind that the very same widget might be sold for $0.99 at your local 99¢ store, $5 at a chain retailer, and $25 at a swank boutique. The price can vary so much because each of these stores has its own pricing strategy—and you should, too.

The concept is simple: Will your business use a high-end, middle-end, or low-end strategy? Each strategy can be profitable if you work within its logic. Here's a quick description of how each strategy typically works:

- Businesses that follow a high-end strategy can charge high prices so long as they offer something in return, such as a great selection of hard-to-find or highly specialized products, extraordinary customer service, an exclusive atmosphere, or simply top-notch quality.
- Companies adopting a middle-end approach charge average prices and succeed on the basis of other factors, such as selection, customer service, and convenient hours and locations. None of these factors are exceptional enough to justify high-end prices, but they're attractive enough to draw customers who aren't necessarily looking for the very lowest price.

- Bargain-oriented businesses succeed by forgoing some amenities, such as a reliable selection or a convenient location. They attract customers by offering the lowest prices. Customers might have to paw through bins of merchandise or drive across town to a cold, cheerless warehouse store, but they'll do it because they know they'll get a bargain.

Whichever strategy you choose, it's important that you stick with it and use it consistently. You will confuse customers and push them to your competitors if you offer a confounding mix of high- and low-end items in the same store.

Another pricing strategy is what's known as a "loss leader" strategy, in which a business sells some items at a very low margin or even at a loss, as a means of attracting customers and steering them towards its higher-margin items. This can work in conjunction with other strategies and is typical of businesses that are new to a market.

What's Up With Markup?

Markup is the amount that's tacked on to the cost of an item to arrive at its selling price. For instance, a wristwatch that cost $25 to the retailer might be marked up by $37.50, for a selling price of $62.50. What can be confusing is that markup rates are sometimes expressed as a percentage of cost, and other times as a percentage of selling price.

For example, the markup percentage for the wristwatch is 150% of cost or 60% of selling price. What does this mean? The percentage of cost calculation works like this: The cost of the watch ($25) is multiplied by 150%, resulting in a $37.50 markup, which is added to its original cost ($25) to arrive at the selling price of $62.50.

Here is the percentage of selling price calculation: The selling price ($62.50) is multiplied by 60%, resulting in the same $37.50 markup arrived at with the percentage of cost calculation. As you can see, these two different ways of expressing a markup percentage yield the same result.

When you search markup rates, be sure you know which type of percentage you're dealing with: percentage of cost or percentage of selling price. If you apply a percentage of selling price markup rate to the item cost, or use the percentage of cost markup with the item's selling price, you'll end up with the wrong result. For instance, if you mistakenly calculate the wristwatch markup by multiplying the item cost ($25) by the percentage of selling price markup rate (60%), you'll end up with a markup of $15, and a selling price of just $40.

Research Markup Data

Once you've got your pricing strategy in place, you must decide how much you'll mark up your products for sale. You can set your prices appropriately after you do some research to figure out how much other similar businesses mark up their goods.

One easy source of markup information is simply the manufacturer's suggested retail price or MSRP, also called the suggested list price. If you buy a line of floor lamps that cost you $30 per unit and the MSRP is $90, then you know the manufacturer is recommending a markup of 200% of cost. You don't have to follow the recommendation (the days of adherence to MSRPs are over), but you'll get a good idea of what might be typical in the marketplace for that item.

In addition to using MSRPs, ask your manufacturers and suppliers for information they have on average markup rates. Your suppliers can be a valuable source of this kind of information, beyond setting MSRPs for each product. You might also find information about industry standard markup rates in trade journals.

Chapter 6 Checklist: Pricing, Bidding, and Billing Projects

- ☐ Never discuss the topic of pricing with competitors—basically, anyone in the same industry as you.
- ☐ If you're in a service business, set hourly rates carefully, by using a formula, basing the rates on market conditions, or a combination of these approaches. However you set your rates, remember that you'll need not only to earn a salary but also to pay for your overhead and make a profit.
- ☐ If you're in a service business, become familiar with various ways to bill clients and understand which methods are best for specific situations.
- ☐ If you will have to bid for work, learn how to put together a professional proposal.
- ☐ If you plan to sell products, develop an overall pricing strategy to guide pricing decisions.
- ☐ If you sell products, research the market to understand what typical markup rates are used by others in your industry.

CHAPTER 7

Federal, State, and Local Start-Up Requirements

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By now you've finished hammering out the details of how you plan to operate your business. In a perfect world, you could hang up your "open" sign and start selling your products or services at a nice profit. Sorry! In the real world of small business, things are not quite that easy. Before you can legally begin your business, you need to take care of a number of pesky requirements with government agencies from the city to the federal level. Although none of these requirements are difficult or even terribly time-consuming, lots of entrepreneurs get stymied at this point because it's so hard to find one centralized source of information that explains what to do. They're left to ferret out each bureaucratic requirement one by one and hope they've found all of them by the time they start doing business.

For example, your city tax office can tell you what forms you must file with them but won't tell you how to obtain a permit in order to sell retail goods. And while your state sales tax agency might be able to tell you everything you need to know about getting a seller's permit, it won't explain how to obtain a federal employer identification number, which is required for most businesses. For many new entrepreneurs, the process of figuring out what you need to do and how to go about doing it can feel like putting together a jigsaw puzzle without knowing how many pieces it should have or how it should look when completed.

To help you make sense of this confounding maze, all the typical bureaucratic start-up requirements are discussed here in one chapter. (Businesses with employees have to meet a few extra requirements, explained in Chapter 16.) By the time you've read through this chapter, you should have a good idea of what agencies are in charge of certain types of requirements, giving you a clearer sense of what government office(s) to contact when you need specific help for your situation.

Entrepreneur's Insight

Jennifer F. Mahoney, owner of an illustration service in Northern California

I'm lucky enough to have a technical skill to combine with a regular drawing skill that puts me in a market niche among illustrators. Lacking any entrepreneurial "uncles," it took me a while to get a clue about the business world, like finding untapped markets, understanding agreements, getting paid, handling copyright issues, and finding out how many regulatory bodies need a portion of my modest income. It all felt like groping in the dark: Where are all the rules written down? I'm doing well for myself now, supporting my family, but I wish it hadn't taken me so long to figure out.

Here are the general start-up steps discussed in this chapter.

Step 1: File organizational documents with the Secretary of State or similar filing office (corporations, LLCs, and limited partnerships only).

Step 2: Obtain a federal employer identification number (EIN).

Step 3: Register your fictitious business name with your county or state.

Step 4: Obtain a local tax registration certificate (also known as a business license).

Step 5: Obtain a permit to sell retail goods and collect state sales tax.

Step 6: Obtain specialized vocation-related licenses or environmental permits if necessary.

"Why Am I Filling Out All These Forms?"

Why do you have to sort your way through a tangled bureaucracy to start a small business? At the most basic level, business permit and license requirements serve three purposes:

- **To identify you.** No matter what kind of business you run, society has an interest in making sure that you are accountable for your actions. That's why businesses that don't use their owners' names as part of their business names must often register a fictitious business name statement with the state or county. That way, a member of the public who has a problem with Racafrax Designs or Acme Sandblasting can easily find out who the owners are, complain to them, and, if necessary, sue them.
- **To protect the public.** Government agencies issue permits and licenses to ensure that your business offers safe products or services that won't harm people or the environment. For example, if you open a food service business, your city's department of health understandably wants to make sure that your kitchen is sanitary and will likely require that you obtain a permit, license, or other official approval before you can start serving snacks.
- **To keep track of your finances for tax purposes.** Several of the registration requirements are based on the government's nasty habit of taxing everything that moves (and lots of things that don't). To be sure that they collect every possible tax and fee, local, state, and federal governments use various registration requirements to keep tabs on your business.

Step 1: File Organizational Documents With Your State (Corporations, LLCs, and Limited Partnerships Only)



SKIP AHEAD

Sole proprietors and partnerships can skip this step. Only corporations, LLCs, and limited partnerships need to file organizational documents with the state. If you're starting a sole proprietorship or partnership, skip ahead to Step 2.

Unlike sole proprietorships or partnerships, businesses that offer limited liability don't just pop into existence as soon as their owners start selling products or services. If you want to create one of these types of businesses, you'll need to take the first step of filing registration papers with your state filing office, which typically is the Secretary of State.

Because these business structures are regulated at the state level, each state has its own rules for creating and managing them. For the most part, however, these laws are fairly similar. For corporations, the organizational document is usually called the articles of incorporation; for LLCs, it's generally called the articles of organization (although some states call it a certificate of organization or formation). Limited partnerships also have to file registration documents with the state. To create any of these business structures, you'll need to do additional reading or consult other resources. (See "Additional resources from Nolo," below.)

When you file your organizational documents with your state, you will usually be registering your corporate, LLC, or limited partnership name at the same time. Typically, the agency in charge (most often the Secretary of State) must approve all names before they can be registered; otherwise, your organizational papers will be rejected. Your name won't be approved if another business of the same legal structure (corporation, LLC, or limited partnership) in your state has already taken the business name you want to use. In other words, a California corporation may not use a name that's used by an existing California corporation, a New Mexico LLC may not use a name that is used by another New Mexico LLC, and so on. Some states check all of their name databases—LLC, corporate, and limited partnership—regardless of what form of business you're creating. To save time and headaches, do some research before you file your papers to make sure your proposed name is available. You can usually call or write to the state filing office to confirm availability. Quite a few states now also allow you to check for name availability online. Ask your state's filing office for its procedure.



TIP

Reserve your name. Many states allow you to reserve a corporate, LLC, or limited partnership name once you've learned it's available. Once the name is reserved, it can't be taken by someone else before you have a chance to file your papers.

It's also very important to remember that just because your name is accepted by your state filing office doesn't mean it's free and clear for you to use. As discussed in detail in Chapter 2, trademark and unfair competition laws may prevent you from using a name used by another business, including businesses that aren't included in your state's corporate, LLC, or limited partnership name databases. For instance, the name of a local general partnership wouldn't be registered in your state's corporate name database but might have been in use for years. Or the name you've chosen might have been taken by a corporation in another state, so it would not appear in your state's database. To avoid running afoul of trademark and unfair competition laws, it's wise to do a trademark search before choosing any name for your business, or for its products or services. (See Chapter 2 for a full discussion of the legal issues surrounding business names.)



RESOURCE

Additional resources from Nolo. Nolo publishes a wide range of information on corporations, LLCs, and limited partnerships. Nolo also offers online LLC and corporate formation services.

Books on LLCs include:

- *Nolo's Quick LLC: All You Need to Know About Limited Liability Companies*, by Anthony Mancuso. Explains the basics of LLCs.
- *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso. Offers detailed information and forms for managing LLCs in compliance with various state and federal laws.
- *Nolo's Guide to Single-Member LLCs*, by David M. Steingold. Gives an overview on how to form and run an LLC with one member, including the unique tax and liability issues.
- *LLC or Corporation? Choose the Right Form for Your Business*, by Anthony Mancuso. Explains the legal and tax differences between LLCs and corporations.

On the corporate side, *The Corporate Records Handbook: Meetings, Minutes & Resolutions*, by Anthony Mancuso, provides forms and instructions for running a corporation and handling corporate meetings and documentation.



TIP

Emerging business structures like benefit corporations and L3Cs must also be created at the state level. If you want to create an entity like a benefit corporation or L3C, first check with your state to see if they allow those business types. If so, the Secretary of State is typically the agency in charge of the paperwork. See Chapter 1 for more info on these business entities.

Step 2: Obtain a Federal Employer Identification Number (EIN)

A business's federal employer identification number (alternately called an EIN or Federal Tax ID) is like a Social Security number for an individual—it's the number used by the government to identify your business. You'll use it over and over again on most of your important business documents, such as on your business's local tax registration forms, your federal tax return, and any applications for business licenses.

Does Your Business Need an EIN?

Some of you are probably saying, "But I don't plan to have employees; why do I need an employer ID number?" Blame the IRS for the confusing terminology. Although it's called an "employer" ID number, EINs are required for most businesses, even those that don't have employees. Exceptions include sole proprietors and single-owner LLCs with no employees, who can use their own Social Security number instead of an EIN. Partnerships, multiple-owner LLCs, and corporations need EINs whether they have employees or not.

Note that if you're a sole proprietorship or a single-owner LLC, IRS rules allow you to get an EIN if you want or need one, say, to open an account with a bank that requires an EIN for business accounts.

Applying for an EIN

Getting an EIN is easy and free. To apply online, you'll need to do it during the hours of operation from Monday through Friday from 7 a.m. to 10 p.m. Eastern Time. Simply go to www.irs.gov/businesses, click on "Employer ID Number, (EIN)" and follow the prompts. Note that you must complete the application in one session, as you will not be able to save it and return to finish it later. Your session will expire after 15 minutes of inactivity, and you will need to start over. Upon completion you will get your EIN right away, and you'll be able to download and print your EIN confirmation notice.

If for whatever reason you can't apply online, you can apply by fax (yes, the IRS still uses fax) or by mail. Note that the IRS no longer issues EINs by telephone for

U.S.-based taxpayers; only international applicants can receive an EIN by phone. Obtain Form SS-4 from the IRS website at www.irs.gov, or by phone by calling 800-TAX-FORM (800-829-3676) Monday through Friday, 7 a.m. to 10 p.m. Eastern Time. You can also get tax forms from local tax offices, and often your local library or community center.

A sample Form SS-4 appears below.

Although much of the information you'll have to put on the form is pretty basic, the following tips will help you get the job done.

Line 1 asks for the legal name of the entity that is applying for the EIN. Sounds simple enough, but, depending on your business, it can get a little tricky.

Sole proprietors should enter a full individual name—first, last, and middle initial. Do not enter a fictitious business name (FBN) you use or plan to use. (A fictitious business name is a name you use for your business that doesn't contain your legal name. FBNs are explained in more detail in the next section.)

A partnership should use the legal name of the partnership as it appears in the partnership agreement. For example, say Gene Cook and Beth Lynch own a partnership that they refer to as "Cook and Lynch, Partners" in their partnership agreement. This is the name they should write on Line 1. If you own a partnership but don't have a written partnership agreement, insert the name you plan to use for all official business and on all government forms—either a business name that contains each partner's last name or the trade name that you will present to the public (also known as your "fictitious business name," or your "DBA name," discussed below). (See Chapter 2 for the full spiel on the various types of business names.)

An LLC should enter the official company name as it appears in its articles of organization (or certificate of organization or formation).

A corporation should use its legal name as it appears in its articles of incorporation (or certificate of organization).

Line 2 asks for the trade name of the business. This is the same as asking for your fictitious business name or your "doing business as" (DBA) name. You can leave this line blank if you plan to do business under the same name you entered on Line 1. For example, if Gene Cook and Beth Lynch plan to do business under the name Cook and Lynch, Partners, and they entered that name on Line 1, they can leave Line 2 blank. Similarly, if a sole proprietor named Stacey Stickler will use just her name to identify her landscape design services, she too can leave Line 2 blank.

Form **SS-4** (Rev. December 2019)
Department of the Treasury
Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)
▶ Go to *www.irs.gov/FormSS4* for instructions and the latest information.
▶ See separate instructions for each line. ▶ Keep a copy for your records.

OMB No. 1545-0003
EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested

2 Trade name of business (if different from name on line 1) | 3 Executor, administrator, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box) | 5a Street address (if different) (Don't enter a P.O. box.)

4b City, state, and ZIP code (if foreign, see instructions) | 5b City, state, and ZIP code (if foreign, see instructions)

6 County and state where principal business is located

7a Name of responsible party | 7b SSN, ITIN, or EIN

8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? ☐ Yes ☐ No | 8b If 8a is "Yes," enter the number of LLC members ▶

8c If 8a is "Yes," was the LLC organized in the United States? ☐ Yes ☐ No

9a **Type of entity** (check only one box). **Caution:** If 8a is "Yes," see the instructions for the correct box to check.

- ☐ Sole proprietor (SSN) _____
- ☐ Partnership
- ☐ Corporation (enter form number to be filed) ▶ _____
- ☐ Personal service corporation
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ▶ _____
- ☐ Other (specify) ▶
- ☐ Estate (SSN of decedent) _____
- ☐ Plan administrator (TIN) _____
- ☐ Trust (TIN of grantor) _____
- ☐ Military/National Guard ☐ State/local government
- ☐ Farmers' cooperative ☐ Federal government
- ☐ REMIC ☐ Indian tribal governments/enterprises

Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

10 **Reason for applying** (check only one box)

- ☐ Started new business (specify type) ▶ _____
- ☐ Hired employees (Check the box and see line 13.)
- ☐ Compliance with IRS withholding regulations
- ☐ Other (specify) ▶
- ☐ Banking purpose (specify purpose) ▶ _____
- ☐ Changed type of organization (specify new type) ▶ _____
- ☐ Purchased going business
- ☐ Created a trust (specify type) ▶ _____
- ☐ Created a pension plan (specify type) ▶ _____

11 Date business started or acquired (month, day, year). See instructions.

12 Closing month of accounting year

13 Highest number of employees expected in the next 12 months (enter -0- if none). If no employees expected, skip line 14.

Agricultural	Household	Other

14 If you expect your employment tax liability to be $1,000 or less in a full calendar year **and** want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be $1,000 or less if you expect to pay $5,000 or less in total wages.) If you don't check this box, you must file Form 941 for every quarter. ☐

15 First date wages or annuities were paid (month, day, year). **Note:** If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) ▶

16 Check **one** box that best describes the principal activity of your business.

☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Accommodation & food service ☐ Wholesale-other ☐ Retail
☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Other (specify) ▶ ☐ Health care & social assistance ☐ Wholesale-agent/broker

17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.

18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☐ No
If "Yes," write previous EIN here ▶

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's **EIN** and answer questions about the completion of this form.

Designee's name | Designee's telephone number (include area code)

Address and ZIP code | Designee's fax number (include area code)

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete. | Applicant's telephone number (include area code)

Name and title (type or print clearly) ▶

Signature ▶ Date ▶ | Applicant's fax number (include area code)

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 12-2019)

But when your company's legal name doesn't match its trade name, you should enter the trade name on Line 2. For example, if Stacey Stickler decides to do business as Stickler's Landscape Design, she should enter "Stickler's Landscape Design" on Line 2. A partnership that wants to do business under any name other than its legal name would do the same thing. For example, if "Cook and Lynch, Partners" want to do business under the trade name "CooLyn Enterprises," they will enter "Cook and Lynch, Partners" on Line 1 and "CooLyn Enterprises" on Line 2. (You'll find more on trade names and fictitious business names just below.)

While these precise instructions might seem like splitting hairs, properly identifying your business is actually quite important. Think about it: The EIN form introduces you and your business to the IRS and identifies you in an official way. Using the correct name will help you avoid snafus with the IRS and other government agencies. For example, if Cook and Lynch alternate between calling their business "Cook and Lynch" and "CooLyn Enterprises" on government documents, they will almost surely experience a raft of bureaucratic headaches.

Line 3 to end of form asks for fairly straightforward information. For advice, see the Instructions for Form SS-4, included with the form.

Step 3: Register Your Fictitious Business Name (FBN)

As discussed in Chapter 2, a trade name that doesn't contain the legal names of the owners (for sole proprietorships or general partnerships) or that doesn't match the company's corporate, limited partnership, or LLC name on file with the state, is called a fictitious business name (FBN). Fictitious business names are sometimes called assumed names, or DBAs, for "doing business as"—as in, "Spikey Andrews, doing business as Coffee Corner," or "Alibi Corporation, doing business as Ferryville Bait and Tackle." Some states simply use the term "trade name," though this can be confusing because it doesn't indicate whether the name is the same as or different from the legal name. In this chapter and the rest of the book, the term fictitious business name will be used for any business name that doesn't contain the legal name of the business owner.

Most states require a business that uses a fictitious business name to register that name, usually with the county clerk in the county where its primary business site is located. This requirement goes by different names, depending on the state: fictitious name certification, DBA filing, trade name registration, or something similar. FBN

registrations are typically done at the county level, although in some states you register your FBN with the Secretary of State or another state agency. The registration process is covered in more detail below.

The Importance of Filing an FBN Statement

Do not neglect or put off registering your fictitious business name. Without proof of registration, many banks will not open an account under your business name. Also, if you don't register your name, it won't appear in any fictitious name databases in your state. This means that another business will be less likely to find out you're using it and might start using the name itself. Even though you have legal avenues to stop another business from using a name that you used first (see Chapter 2), you don't want to create customer confusion between the two businesses and get into a name dispute with another business. If you lose a dispute over a name, at the very least you'll have to redo stationery, signs, and anything else that contains the name, such as T-shirts or maybe even your company logo.

Who Needs to Register

The rules you'll need to follow for registering your fictitious business name will depend on which business structure you use.

Sole Proprietorships

Generally speaking, sole proprietors who include their last name in the business name—such as O'Toole's Classic Cars—do not need to file an FBN statement. But it is not enough to include only initials and a nickname or part of a name. For example, a business called J.R.'s Classic Cars would likely have to file a fictitious name statement indicating that it really is John O'Toole's business.

In addition, in many states, if your business name falsely implies that more than one owner is involved, you must file a fictitious business name statement. If Jason Todd were a sole proprietor, for example, and named his business Jason Todd and Sons or Jason Todd & Associates, he would probably have to file an FBN statement, even though he included his last name in his business name. Check with your county clerk for your state's rules.

Partnerships

If a partnership includes the last names of all the partners—for example, Lawrence Anderson and Nancy Fawcett name their business "Anderson and Fawcett Metal Designs"—they don't have to file a statement. Otherwise, an FBN statement will be required. For example, if three partners, Lynch, Cook, and Briggs, did business only under the name "Lynch & Cook," they would have to file an FBN statement. Check with your county clerk for your state's specific rules.

Corporations, LLCs, and Limited Partnerships

A corporation, an LLC, or a limited partnership does not need to file an FBN statement unless it operates under a name that's different from its official name as stated in its articles of incorporation, articles of organization, or certificate of limited partnership. For example, an LLC that registered with the Secretary of State under the name "Landmark Lanes, LLC" wouldn't have to file an FBN statement as long as it conducted business under that name. Any other trade name, "Landmark Bowl," for instance—or even "Landmark Lanes" without the "LLC" tacked onto the end—might be considered to be "fictitious" and would have to be registered. The same is often true for corporations: If "Inc." is included in the corporation's name in the articles of incorporation, but not in the company's trade name, an FBN statement usually must be filed. Check with your county clerk, Secretary of State, or other state filing office to determine your state's specific rules.

Filing With Your County

In some states, FBN registration is accomplished through the Secretary of State or another state agency; however, in most states, you'll register your FBN at the county level (despite the fact that most laws governing fictitious business names are state laws). The result is that each county in your state may have different forms and fees for registering an FBN. Your first step should be to call your county clerk's office to learn its requirements and fees. Some counties allow you to order the FBN registration form by phone or download it from their website; others require you to request it in writing with a self-addressed, stamped envelope. Unless you live a good distance from the nearest county clerk, it might be easiest just to go to the office and complete the form in person.

Searching the County (or State) Database

In many areas, you'll be instructed to search the county or state database of registered fictitious business names before submitting your statement to make sure no one else has already registered the name you want to use. Your county might have a searchable online database, or you might be required to go to the office in person to do the search. Sometimes you can pay a fee for a staff person to do the search for you. If you want the clerk's office to do the search, you must usually submit the request and fee by mail.



CAUTION

County databases won't tell you if a name is trademarked. Oftentimes, fictitious business names are registered at the county level, and you may be required to search your county database before registering your fictitious name to make sure it isn't already registered. Ironically, this requirement may well do more harm than good. The reason is that lots of people who find that no one in the county has registered a certain name are misled into believing that the name is available to use. The truth of the matter is that someone in a different county, state, or even country might own trademark rights to that name.

Only owners of the tiniest of businesses can feel safe by doing merely a county-wide search of a name they want to use. If someone else has trademarked that name, you may well run into legal trouble, depending on your geographical scope and the products or services you sell. Particularly with the explosion of e-business, geographical distance is becoming irrelevant as the internet makes neighbors out of businesses on opposite sides of the globe.

To avoid being accused of unfair competition or trademark infringement, it is wise to check neighboring counties' FBN databases, look into state registries of corporate and LLC names, or even do a full international trademark search. Failing to do an appropriate search puts you at risk not only of lawsuits, but also of having to change your name down the line when you already have stationery, business signs, and invoices printed. (See Chapter 2 on trademark and business name issues for more information on choosing and researching a name that won't get you into legal trouble.)

Completing and Submitting an FBN Statement

If the name you've chosen is available (both at the county level and with regard to trademark issues), simply fill out the FBN statement and submit it to your county clerk (or other agency, depending on your state) along with the appropriate fees. You typically can submit the form in person or by mail. Depending on the state and county, fees range from $10 to $125 for registering one business name and one business owner. Sometimes you will be charged an additional fee, around $5 to $15, to register additional business names to be used at the same business location or to register additional owners.

Publishing Notice of Your FBN Statement

Once you've filed your name and paid the necessary fees, you might have one more task to complete before you start doing business under that name. Some states require you to have your FBN statement published in an approved newspaper in the county where you filed it. The county clerk or state agency will provide a list of acceptable publications for posting your FBN statement, though usually any newspaper of general circulation in the county will suffice. Publishing your statement is usually simple: Just submit your statement to your publication of choice, which will have a standard format to present the required information.

The published notice must run for a certain frequency and duration, usually once a week for a month or so. After the FBN has been published for the required period, you'll usually need to submit an affidavit (sometimes called proof of publication) with the county clerk or state agency to show that publication has been completed. Many newspapers that provide publication services will automatically send in the affidavit for you after your ad has completed its run. Make sure to find out whether the publication you use will do this (and double-check afterward to make sure it has actually done it). If not, you'll have to get the affidavit from the publication yourself and submit it to the county clerk or state agency by the prescribed deadline. If the affidavit isn't filed in time, you might have to start the process all over again.

Check with your county clerk for the details and requirements of publishing the FBN notice.



TIP

Save your ad receipt. For practical reasons, you might need to prove that you completed your fictitious business name filing requirements—including publication—before your ad has actually completed its publication run. Banks, for instance, want to see that you have met fictitious name rules before they allow you to open an account in that name. Fortunately, a receipt from the newspaper showing that you have paid for publication, along with a copy of the FBN statement certified by the county clerk or state agency, is generally sufficient to prove that you've met all the registration requirements, even though the ad hasn't yet run for four weeks. So be sure to get a certified copy of your FBN statement from the county clerk or state agency when you submit it, as well as a receipt from the newspaper when you pay for publishing it.

After You File

Your FBN registration will be good for a certain period of time, usually for five years or so (although the period can be as short as one year and as long as indefinite), before it must be renewed. You (or someone at your business) should keep track of your expiration date, as your county clerk or state agency might not notify you when your renewal date approaches. Also, if certain facts in your statement change, such as the number of owners or your business address, you might have to renew your FBN statement before its expiration date. Check with your county clerk or state agency to find out which types of changes trigger a renewal requirement. If you no longer want your FBN registered, you may file a form (often called a statement of abandonment), which will cause the registration to expire.

Step 4: Obtain a Local Tax Registration Certificate

Most cities require all businesses (including home businesses) to register with that city's tax collector, regardless of business type, structure, size, or name. Businesses located in rural, unincorporated areas must usually register with the county clerk rather than a city tax collector. (While this section often refers to city tax collectors and city requirements for businesses, keep in mind that if you're operating outside of a city, the same types of requirements generally apply but are administered by county government.)

Localities use various names for the registration process: tax registration, business tax application, business license application, or tax certification. This book uses the terms "tax registration" and "tax registration certificate"—and it's best if you don't use the term "business license" when you really mean "tax registration certificate" (or whatever term is used in your locality for tax registration). True licenses, which are discussed in Step 6, below, are typically administered at the state level. Certain businesses must obtain them if they engage in regulated activities, such as selling alcohol or cutting people's hair. Getting such a license often involves taking a test or otherwise proving you're qualified to do a certain activity.



TIP

Some businesses need to satisfy more requirements. Your tax registration certificate is not the same as a specialized license your business might need—such as a permit from the local health department for handling food, from the Federal Communications Commission for broadcasting over the radio waves, or from a regional air management district for emitting particles into the air. (Step 6, below, discusses these specialized licenses and permits.) Whether or not you need one of these licenses or permits, you'll still need to get a tax registration certificate.

The reason you need to register with your local tax collector is that, just like the federal and state governments, your local government wants a cut of your business income. The tax registration requirement is basically your local government's way of keeping track of your business so that it will be able to collect any taxes due.

Cities and counties have been known to tax businesses with even more flair and creativity than the feds or the states. Localities tax businesses based on criteria such as net profit, gross income, number of employees, total payroll, number of vehicles, number of machines, and sometimes even seating capacity.

In addition, most cities categorize businesses and use particular tax structures for each category. Philadelphia, for example, charges a 5% tax on admission charges for amusement businesses, and 7% of the purchase price for outdoor advertising sign companies. There also may be special taxes for particular activities. In Chicago, for instance, businesses that sell soft drink syrup or fountain soft drinks must pay an extra "Fountain Soft Drink" tax of 9% of the syrup price, and businesses that offer sightseeing boat rides must pay an extra "Amusement Tax" of 9% of the ticket price.

For the privilege of registering to pay local taxes, you'll usually have to pay an annual fee, which varies from city to city but is generally in the $25 to $100 range. Sometimes the annual fee depends partly on how much tax your business is expected to owe the following year, based on city (or county) tax rates. If the fee is based on estimated taxes, at least part of the registration fee may be a nonrefundable administrative fee. In that case, the other part of the fee will go toward paying your estimated taxes or will be returned to you if your taxes turn out to be lower than expected. In San Francisco, California, for instance, the registration fee is based on your gross receipts for the previous year.



CAUTION

Local rules can change without notice. Be sure to check with your local office for the most current rules and rates. The information here was current when this book went to press, but these rules often change. The point of this discussion is to give you a taste of the various ways local governments handle business taxes. As you can see, there's a lot of variation.

For your city's requirements, call your city tax collector or check your city's website. The tax collector's office will be able to give you the forms necessary to register in your city, as well as any breakdown of business categories and tax tables. If you're doing business outside city limits, call your county clerk, usually listed under "County Clerk" in the county government section of the phone book, or check your county's website.

Step 5: Obtain a State Seller's Permit

In most states, any business—whether it's a sole proprietorship, an LLC, a corporation, or any other type—must have a seller's permit if it sells any tangible goods to the public. Tangible goods are things you can touch, such as furniture or food. Businesses that sell only services are often exempt from

the seller's permit requirement. In the five states that do not impose general sales taxes (Alaska, Delaware, Montana, New Hampshire, and Oregon), you may not be required to get a permit for most sales transactions. However, local governments, such as cities and counties in those states, may charge sales taxes (as in Alaska), and certain transactions in those states may be subject to something similar to a sales tax, though it may have a different name. If you live in one of the nontaxing states, be sure to check with the sales tax agency to find out if your specific transactions will be subject to tax and if you'll need a seller's permit.



CAUTION

States are getting much more aggressive about taxing sales conducted online. If you plan to conduct sales online, make sure you understand whether those sales will be taxable. In a nutshell, online sales that used to be considered nontaxable because they were made to out-of-state buyers are the subject of a flurry of state legislation, as states are attempting to define many of these sales as taxable. See Chapter 9 for a more detailed discussion of sales taxes online.

In states that do charge sales taxes, a seller's permit will allow your business to collect sales taxes from customers to cover any sales tax that you'll owe to the state. You'll typically pay any taxes you owe at year end, semiannually, or quarterly. You might have to pay some of them monthly. The general rule is that the higher your sales volume, the more often you'll owe your payment.

It's important to understand that if you plan to sell tangible goods, you'll often need a seller's permit whether or not those sales will be taxable. For instance, most states exempt certain sales from state sales tax, such as sales of food or sales to an out-of-state customer. But, in most states, you'll need a seller's permit even to conduct these types of nontaxable sales. This means you need to get a sales permit before you begin to sell tangible goods; when the sales are made, you'll distinguish the taxable ones from the nontaxable ones. When it comes time to report and pay sales taxes to the state, you'll owe tax only on the taxable sales. (See Chapter 9 for a detailed discussion of reporting and paying sales taxes.)



TIP

Keep track of your service and product sales separately. Many businesses both perform services and sell products. A jeweler, for instance, both repairs jewelry and sells raw materials, such as precious metals and gemstones. If a business sells both labor and goods, it will need a seller's permit (assuming it's in a state that requires one). Plus, to assure proper tax reporting, that business will need to keep its labor sales separate from sales of goods, because sales of services aren't taxed in most locales. (Chapter 12 explains simple bookkeeping and how to account for taxable sales separately from tax-exempt sales.)

To obtain a seller's permit, contact the agency in your state that governs sales taxes.

The process of obtaining a seller's permit typically consists of submitting a simple application form and sometimes paying a fee. Some states require a deposit from businesses that have a blemished history of not paying their sales taxes on time.

Step 6: Obtain Specialized Licenses or Permits

Depending on the nature of your business, you might be finished with your list of bureaucratic tasks. But before you run off to rev up your cash register, cool your jets—you may be surprised to find out that even your simple little business is subject to an extra regulation or two. Some business activities are prohibited until you obtain a license or permit to engage in them, and some business locations require special approval from the local planning department. These extra requirements are especially likely to apply to your business if it has any potential for harming the environment or hurting the public, but they also apply in lots of seemingly risk-free situations.

Figuring out what additional permits or licenses you might need can be confusing, because literally hundreds of independent agencies, from the local to the federal level, regulate various businesses. Obviously, you don't want to waste your time calling each and every one of them to find out whether your business is subject to its rules. This section will help streamline the process by first outlining the basics of what types of activities are generally regulated and by whom. This should help you figure out when your business is likely to face a special regulation. Then you'll find here a few resources that help to make sense of the crazy patchwork of local, state, and federal regulations that might apply to your business.

Zoning and Local Permits

Local business regulations usually deal with the physical location of the business and the safety of the premises and equipment (state and federal regulations usually focus on the type of work you do and your qualifications). City zoning laws regulate which activities are allowed in particular locations. For example, your zoning board might not approve your business location if it's in an area zoned exclusively for residential use, there isn't enough parking to support your business, or there are too many similar businesses nearby. Even if your business activities are acceptable for the time being, you might not be allowed to put up the sign you want or put in additional seating once your business takes off.

If your business doesn't comply with zoning laws, you'll either need to get a permit known as a conditional use permit or be granted an exception to the law, sometimes called a variance. Your city or county planning department is generally in charge of zoning laws. Contact them to find out whether your business complies with local rules and, if not, how to request a conditional use permit or a zoning variance. (Chapter 3 discusses zoning laws and picking a business location. Chapter 10 discusses zoning specifically for home businesses.)

Assuming your business has met zoning requirements, it still might need to be approved by other city agencies, such as the fire or police departments, the building inspector, or the department of public health. To ensure compliance with local laws, such as health and fire codes, noise laws, and environmental regulations, you might need one or more permits from these agencies. When you register with your local tax collector, you might receive information on these agencies and which types of businesses need to contact them. Your county clerk might also be able to direct you to information about regulatory agencies in your area.

Entrepreneur's Insight

Audrey Wackerley, former owner of Retro Fit, a vintage clothing store in San Francisco

Getting the right permits turned into a total hassle for our clothing store. After we'd been in business for a year and a half, a cop walked in our store and said we needed a "second-hand" permit. We had never even heard of one! It's not like we hadn't really made an effort to get all the permits we needed. Before we opened we spent hours in all these different buildings downtown, waiting in endless lines (it's a lot like going to the DMV), asking a million questions to find out what permits we needed to open our store. We had a business license, a seller's permit, a sign permit ... we thought we had everything we needed. But all of a sudden this cop said he'd shut us down if we didn't get the second-hand permit within five days. Five days! The permit cost $700, which was a real stretch for us right then. But what could we do? We had to scramble to get the money together and buy that stupid permit. The cop also let us know that we needed a separate jewelry permit in order to sell jewelry, but getting the second-hand permit was enough of an ordeal. We just decided to stop selling jewelry.

State and Federal Regulations

State regulations often focus on how you conduct your business. For instance, your state wants to make sure that your cosmetologists are competent and that your carpenters do safe work. Your state regulates these business activities through licensing. Businesses are more likely to need a state license or permit if they are highly specialized or if they affect the public welfare. In other words, if there's a risk that poor handling of your business activities might harm the public, chances are good that a state license is required. Common examples of state-licensed businesses are bars, auto shops, health care services, and waste management companies.

Entrepreneur's Insight

John Tilles, cofounder of Portland Kayak Company, a river rafting outfit in Portland, Oregon (www.portlandkayak.com)

I was impressed by Oregon's straightforward and simple process for starting a business. On the other hand, the absolute toughest and most frustrating aspect of our business is staying on top of the permit regulations in order to use state and federal land and rivers. This is a constantly changing scenario, and the politics involved are often nonsensical.

Don't assume that your business is so simple or straightforward that you don't need a special license. You'd be amazed at how many activities states regulate.

To name a few, locksmiths might need a license from the Bureau of Security and Investigative Services; people who train guide dogs might need one from the State Board of Guide Dogs; and furniture makers can be subject to licensing from the Bureau of Home Furnishings. If you think some of these regulations sound far-fetched, take a look at a list of your state's regulatory agencies.

The federal government doesn't regulate small businesses as heavily as local and state offices do, but you might need a federal permit or license to engage in certain activities, including:

- operating a common carrier for hire, such as a trucking company (Interstate Commerce Commission)
- constructing or operating a radio or television station (Federal Communications Commission)
- manufacturing drugs or meat products (Food and Drug Administration)
- manufacturing alcohol or tobacco products, or making or selling firearms (Bureau of Alcohol, Tobacco, Firearms, and Explosives), and
- providing investment advice or counseling (Securities and Exchange Commission).

License and Permit Information Resources

Fortunately, many states have special agencies that act as clearinghouses for information on permits and issuing agencies, and several of them have very helpful websites. If you aren't sure what regulations might apply to your business, see if your state has such an agency and, of so, contact it.

Chapter 7 Checklist: Federal, State, and Local Start-Up Requirements

- ☐ File organizational documents with the Secretary of State or similar filing office (corporations, LLCs, and limited partnerships only).
- ☐ Obtain a federal employer identification number (EIN).
- ☐ Register your fictitious business name with your county or state.
- ☐ Obtain a local tax registration certificate.
- ☐ Obtain a permit to sell retail goods and collect state sales tax.
- ☐ Obtain specialized vocation-related licenses or environmental permits, if necessary.

CHAPTER

8

Risk Management

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As covered in Chapter 1, creating a corporation or an LLC generally protects business owners from personal liability. If the corporation or LLC loses a lawsuit or otherwise finds itself in debt, only the business will be liable for the debt, not the owners. But in a partnership, each partner is 100% personally liable for all the business's debts and obligations. True, these debts should normally be shared among the partners, and one partner can sue the others to force them to pay up. But this not a very satisfying option if the other partners are broke or have disappeared.

Shielding owners (or employees, as discussed below) from personal liability is a totally different issue from shielding the business itself. In fact, when an individual owner or employee avoids personal liability, you can usually assume that the business will be stuck with it. The owners and employees might be happy they are not personally liable, but there's not much to cheer about when the business assets are wiped out to satisfy a judgment.

The bottom line is that a successful lawsuit against a business can be devastating, whether or not the owners are personally liable for the damages. No matter who ultimately faces liability, every business should consider where risks lurk and how to avoid them. In our litigious society, you must take liability issues seriously and take steps to protect your business and yourself.

Though the world of possible lawsuits is limited only by lawyers' imaginations, most claims arise from predictable—and often preventable—situations. If you analyze the true risks that face your business and employees, you can learn to recognize where your business is truly vulnerable and reduce the likelihood of ending up in court.

This chapter outlines the typical risks your business might face, and offers guidance on how to reduce them. It also discusses who and what can be at risk—including the owners, the staff, and the business itself. Then it offers risk management strategies and techniques to reduce your exposure to liability.

The encouraging news is that you can do a lot to protect yourself and your business. Hiring carefully, training thoroughly, having solid personnel policies in place, maintaining a safe working environment, and purchasing insurance are important risk management techniques that all businesses should use. It's crucial to do as much as you can *before* any legal issues arise.



SEE AN EXPERT

Get advice on possible liability claims. Liability issues typically involve gray areas, so the only way to determine absolutely whether someone will be held responsible for a particular act is to find out in court—an expensive way to get an answer. Use the information in this chapter as a foundation for understanding what can go wrong, and do your best to reduce your risks, but consult an attorney if you fear possible legal trouble. And run, don't walk, to an attorney if you receive an official document such as a court order, a subpoena, or a written complaint that signals the start of a lawsuit. (See Chapter 17 for advice on finding and working with an attorney.)

Who Might Sue or Be Sued

Pretty much anyone you deal with in your business can sue you or the business, and vice versa. This section lists what could possibly go wrong for a business, divided according to which people are involved. You can read it as a checklist now, or come back later to make sure you've covered the most likely risks for your business.

A typical claim or lawsuit that could be brought by or against your business will be over a contract or agreement of some sort. That's because businesses routinely buy, rent, make, sell, or provide products or services—and all of those transactions involve contracts, whether written or oral. Small business problems tend to be money-related, whether it's getting paid by reluctant clients or insurers or meeting their own financial obligations by paying their suppliers, landlord, or employees. Problems like these are called "contract" claims, because they stem from contractual agreements.

Another type of risk is that someone in or around your business could be injured—financially or personally—by some act not related to a contract. For example, if one of your employees injures someone by acting carelessly (negligently, in legal terms), typically the business will be liable. A lot of your risk management efforts will be directed at preventing these kinds of claims—called "torts" in legalese—because they can be very costly to you and your business.

Co-Owners

If you are a co-owner of your business, you and the other co-owners have many obligations to each other. That's because mismanaging the business, whether on purpose or unintentionally, can damage the owners' investment and may expose all owners to liability.

Claims between and among owners can arise from one owner's:

- lying—for instance, about cash flow or customer complaints
- self-dealing—working for personal interests instead of the business's
- stealing the business's money or taking business assets for personal use
- handing out profits incorrectly
- selling property for less than it's worth
- conspiring—for example, to defraud or push out one of the co-owners
- failing to live up to the business agreement—for instance, by not contributing the agreed-upon amount of time and money
- mishandling company funds
- mistreating the employees
- making obviously bad deals (deals that no reasonable businessperson would make)
- producing bad products or providing poor service
- defrauding lenders, customers, landlords, or suppliers
- failing to pay payroll and/or income taxes
- violating laws and regulations of various kinds: safety or securities regulations, local ordinances, employment laws, or antitrust laws
- failing to properly hire, train, and supervise employees
- failing to observe formalities, such as recording corporate minutes, or
- keeping personal money separate from business money.

As if this list isn't daunting enough, additional claims involving those who venture into business together can arise. For example, even if you've done nothing wrong personally, a partner could sue you for your share of partnership debts, which may result in an expensive verdict or settlement. If your co-owner is your spouse and you get divorced, the business could get mired in the tussle over marital assets. Or if you and your co-owners decide to stop being in business together, you could sue each other over mismanagement, unfair competition, wrongfully expelling a partner, or irregularities stemming from the breakup.

Landlords, Customers, and Other Parties to Business Contracts

Business contracts are a common source of claims and problems. Lenders, suppliers, landlords, and customers could sue you—just as you could sue them—over contracts. For instance, your landlord could claim rent was in arrears or that you damaged the premises. Or you could sue your landlord for failing to make promised repairs or improvements. You could take over a lease or a contract and find that you

are obligated for more than you agreed to take on. Customers could claim that your goods are shoddy and your return policy inadequate. Or you could have a supplier who gives you substandard goods.

Injuries outside of contractual agreements are the other main risk. Claims can be based on acts that were either intentionally bad or just unintentionally unfortunate. Customers could be accidentally injured on your premises or by your products. You or another partner could physically assault, harass, or make racially derogatory remarks about a supplier or customer. Your customers could claim that you were not careful enough in hiring, training, and supervising your employees—who subsequently hurt someone or something. You could have a claim if a business contact assaults your employee or steals your property. The people who hire your former employee could claim you gave a falsely positive recommendation.

Employees

Employees can be the targets and sources of liabilities and lawsuits.

Owner's Claims Against Employees

A business owner may sometimes be compelled to sue an employee. Theft and property damages are common reasons—although it might not be cost-effective to take a pilfering employee to court for small reimbursements or money owed for small repairs.

In almost every case, someone who is injured by your employee will choose to sue you—not the employee. An injured person nearly always looks for a way to sue the employer, who usually has assets, including insurance. An employer who has to pay an injured person for harm caused by an employee could theoretically sue the employee for reimbursement, but it's not worth the trouble if the employee has no money.

A rare but important problem is that employees sometimes steal customer lists or a secret process or invention, then go into business in competition with their former bosses. An employee with a head full of business information and years of experience in the field can be a formidable competitor, even without stealing trade secrets or a customer list.



RESOURCE

For more information on restricting business information. State laws vary considerably on how much and for how long you can effectively restrict a former employee or associate from going into competition with you. For guidance, go to www.nolo.com and search for "nondisclosure agreement," which will pull up downloadable forms as well as free articles.

Owner's Responsibility for Claims Against Employees

A business owner's responsibility for harm done by an employee is an area of potentially very serious liability. An employer may be held responsible for the harmful acts of an employee in two ways: when the employer is at fault in some way, and when the employer isn't at fault at all. This is surprising, but unfortunately true.

In general, an employer is liable for everything an employee does "within the course and scope of employment," because the employee acts as the employer's agent. This means that for legal purposes, it is as if the employer directed an employee's every move, simply by authorizing the employee to act. For instance, the U.S. Supreme Court held that a real estate corporation was "vicariously liable" for its salesman's illegal discrimination when he refused to accept a biracial couple's offer to buy a house. (*Meyer v. Holley*, 537 U.S. 280 (2003).) The ruling expressly held that the corporation's sole owner was not personally liable. This effectively protected the corporation owner's other assets by limiting liability to the corporation itself—exactly why some business owners choose to incorporate.

An employer obviously should be held responsible when the employer tells the employee to do something and the employer knows that act will probably cause harm. An employer who knows or should know that the employee is harming someone or something will also be held culpable.

Liability for Independent Contractors

An independent contractor is someone who works for you but is not a regular employee. (For a discussion of the differences between an independent contractor and an employee, see Chapter 16.)

Employer liability for an independent contractor's acts is a complex area. Because typical independent contractors work offsite, using their own equipment, without direct supervision, a business owner usually has little control over how the contractors do the work. Nonetheless, the employer may still be liable to anyone who is hurt by the finished product that the independent contractors produces—for instance, if the employer uses the product at the business site or sells it to the public.

Fortunately, independent contractors often have insurance, so a businessperson who is sued can in turn sue the independent contractor for mistakes. For more information see *Consultant & Independent Contractor Agreements*, by Stephen Fishman, and *The Employer's Legal Handbook*, by Fred S. Steingold (both published by Nolo).

Risks Facing Employees

Employees may have to pay an injured person for damages for injuries they cause at work by:

- failing to act reasonably and carefully—for example, working without enough sleep when they need to stay alert
- acting with reckless disregard for the safety or interests of others—for example, removing safety equipment from a machine or ignoring warnings, or
- hurting someone deliberately or breaking the law.

If the person injured is a coworker, the legal relief is usually limited to workers' compensation benefits.

In addition, an employer is often legally responsible for an employee's acts—even when the employer did not direct the employee to do the act that caused the trouble and didn't know that the employee was doing it—if the employer *should have* done something to prevent the situation from arising. For example, an employer may be liable for carelessness in hiring, training, or supervising an employee who causes some harm on the job. This can be true even when the harm happens after work hours or away from the work premises, as long as there is some connection to the job.

Claims by Employees Against Owners

Employment-related claims pose a major liability risk to businesses with employees. Lawsuits alleging wrongful termination, sexual harassment, or other types of illegal discrimination are a serious risk to all businesses—and possibly to individual owners, managers, and employees. Here's an extremely brief and simplified outline of the types of workplace-related suits commonly faced by businesses.

Wrongful Termination

In every state but Montana, every employee without a written employment contract has a job only as long as both the employer and the employee agree to continue the employment. An employee can quit at any time, for any reason or no reason, and the employer can fire the employee any time, for any or no reason. This is a legal doctrine called "employment at will."

This general rule has major qualifications, however, which can open an employer to a lawsuit for firing a worker. For instance, an employer can't fire someone for an illegal reason, such as wrongful discrimination (discussed below), in retaliation for union organizing, or whistleblowing—reporting the employer's wrongdoing to a government agency.

In these cases, the employees can sue their former employers for wrongful termination.

Employees who have written contracts setting out conditions of termination—an increasingly rare situation—can sue a business on a claim that the company did not have "good cause" to terminate the employment. This is a "breach of contract" claim. Most businesses avoid these claims by making it clear in writing that all their employees are at will.

Defamation

A business that gives out false and damaging information about a former employee may be sued for harming that individual's reputation—also called defamation.

Defamation may rear its head for business owners and managers who are asked to give references for former employees. In most states, employers have a legal defense called a "privilege," which protects people who give job references in good faith or when negative information is true. However, if you are sued for defaming a former employee, it would still cost time and money to prove that defense in court and win the case.

In spite of the defense of good faith or truth, it is always possible to argue about the truth of subjective evaluations and personal experiences. To avoid this morass, some managers refuse to comment at all about any former employee, except to confirm that the employee worked for the business and when. Though this policy might be wise for problem former employees, it also limits the opportunity to pass along good information about good workers. It's best to use discretion.

Business owners and managers should also beware of the possibility of defaming a worker during the firing process, when emotions often run high. It's always wise to keep termination discussions brief—and tied to specifics about an individual's work performance.

Sexual harassment

Sexual harassment is any unwelcome sexual conduct on the job that creates an intimidating, hostile, or offensive work environment—and by now you're surely aware that it can expose a business to liability. Some courts categorize harassing behavior as either "quid pro quo" or "hostile environment." In quid pro quo harassment—literally, "do this for that"—a worker is confronted with demands for sexual favors to keep a job or get a promotion. Hostile environment harassment is found when sexual jokes, pictures, innuendoes, or comments are allowed to persist in the workplace.

A business can help avoid these types of claims by putting a strong sexual

harassment policy in place and strictly enforcing it—along with offering periodic training for all employees on how to recognize and report sexual harassment on the job.

Illegal discrimination

Federal law prohibits discrimination in employment based on race, skin color, gender, religious beliefs, national origin, disability, or age. State and local ordinances sometimes protect additional characteristics, such as marital status, obesity, or sexual orientation. These laws make it illegal to use any of these factors in decisions about hiring, promoting, making job assignments, firing, or paying workers. It is even a bad idea to ask questions about those parts of an applicant's background before the business gives the offer to hire. Savvy businesses use clear job descriptions, review standards, and termination guidelines to avoid claims of discrimination. And, of course, epithets or hostility on the job based on these protected characteristics should not be tolerated.

But discrimination law can get more complicated, making it necessary to pay attention to reality rather than blindly enforce workplace policies. An apparently neutral job requirement might disproportionately harm members of a protected group. For instance, in several states, black male employees have successfully challenged grooming codes requiring all workers to be clean-shaven, based on medical evidence that black men are disproportionately likely to suffer from a skin disorder giving them painful ingrown hairs after shaving.

A growing number of discrimination complaints these days are filed by employees who have disabilities. A federal law, the Americans with Disabilities Act, requires an employer to make "reasonable accommodations" for an employee who has a disability but is otherwise able to do the job—as long as the employee requests an accommodation and the business can provide it without suffering hardship. The accommodation could involve buying a special chair, computer, or other equipment; or installing a safety bar in the restroom. An accommodation can also mean allowing the employee to reduce work hours to undergo chemotherapy, or reassigning an employee to a job that requires less lifting or standing.

How far you must go to accommodate an employee varies depending on the facts of each situation. You need not always provide the most expensive accommodation or the exact one an employee requests. At a minimum, you and your employee should discuss and negotiate what accommodations are possible and reasonable.

The Americans with Disabilities Act also requires many businesses and buildings to be made accessible to people with disabilities. Not complying with that law is another form of illegal discrimination.

Another growing area of discrimination claims arises from bringing religion into the workplace. Employees might complain that they are being harassed by evangelical coworkers of a different religion or upset by required prayers at business meetings. But if the business forbids all religious practice, employees might claim that they have a right to practice their religion at work, including praying and proselytizing. Employers often react by restricting religious and personal postings to a designated bulletin board and prayer groups to nonwork times. However, a business should generally accommodate employees' religious practices, including allowing religious garb and scheduling around religious holidays.

Privacy

The flip side of bringing an employee's personal beliefs into the workplace is that many employees do not want an employer to know about their lives outside the office. Be sure to check the laws in your state before you start monitoring employees' off-duty pursuits, social media activity, or drug use. A manager who inquires about whether an employee went to church on Sunday might be both invading privacy and appearing to discriminate based on religious beliefs.

Recent years have seen a great deal of legislative activity regarding what employers may do in terms of monitoring employees' activity on social media. Federal laws prohibit employers from discriminating against an employee or applicant based on information they glean from social media related to the individual's race, color, national origin, gender, age, disability, or immigration status. More specific laws regarding employers' access to or use of social media information about employees or applicants exist at the state level. Several states have passed laws prohibiting employers from requiring passwords or login information from employees for their social media accounts.

Laws vary a great deal from state to state, so if you have any plans to track your employees' or applicants' social media activity and use that information in hiring or termination decisions, be sure to learn your state's laws. One good source of updated information is the National Conference of State Legislatures website at www.ncsl.org.

In some states, a business may legitimately require a drug test prior to offering a job. The employer may also require drug testing on the job if the employer can point to specific and significant reasons why drug testing is necessary, such as when employees handle dangerous machinery or drive on the job. However, many potential

legal hazards can be addressed simply by having a rule that forbids being "under the influence" of any substance at work.

An employee can be held responsible for truly dangerous or inappropriate behavior without requiring an invasive or humiliating test. Keep in mind that some prescription and over-the-counter drugs also can temporarily affect an employee's mood or concentration.

Personal injuries

An employee who is injured on the job cannot usually sue the employer or another employee for damages, because state workers' compensation laws provide insurance benefits to cover those injuries. State or private disability insurance might also help compensate an injured employee, although only a handful of states have disability insurance programs.

People Unrelated to Your Business

People whom you never expected to come into contact with your product or service could nonetheless be injured by it. In some states, even trespassers who get injured on your property can sue you. And you or your employee might get into an auto accident in a company car, or on company business, and sue or be sued. You might also commit a crime that, as a side effect, harms someone.

Risk Management Strategies

"Risk management" refers to actively addressing, managing, and reducing risks for a business. It is a rapidly growing field, partly because of the widespread and realistic fear of lawsuits. Your first goal is not to win a lawsuit, but to avoid a claim altogether. Your second goal is to resolve a claim without a lawsuit. Only as a last resort should you venture to court, because it's usually very expensive, and the outcome is always a gamble.

Insurance is part of a risk management program, but beware that it does not in itself constitute risk management. Sometimes the protection of insurance is adequate, but in some cases insurance is too expensive or simply unavailable for particular activities. (See "Insurance and Warranties," below, for more specifics on insurance.)

Here's an example of how an entrepreneur could approach risk management. Consider Teresa, a computer hardware technician planning to open a repair shop. Before taking any customers, she evaluates the possible scenarios that could go wrong and expose the business to legal liability. To start, Teresa lists the types of repairs that she knows are the most common and would likely constitute a large portion of her work. She reviews that list and thinks about typical ways that customers could suffer loss related to her repair shop's

work: hard drive failures that result in loss of data, electrical problems that damage peripheral equipment, breach of personal information privacy if hard drives are not disposed of properly, etc.

Next, Teresa addresses each of these possible problematic scenarios by thinking of how her business practices could minimize the risk. One of the first opportunities to do this in a typical transaction with a customer is to set expectations. Doing this well can go a long way towards avoiding conflict down the road. Teresa approaches the "expectations setting" task with two prongs: (1) drafting written Standard Terms for every customer to sign that clarify some of the realities (such as possible data loss), and (2) outlining a checklist to guide her or her staff to make sure the important points are discussed with the customer during intake. She also decides to add an extra layer of protection by drafting a helpful one-page guide for customers with tips about data backups and security protection.

Next, Teresa considers what happens if setting expectations does not successfully prevent a customer from suffering a loss and claiming her shop is responsible. She adds to her Standard Terms some language clarifying that her shop is not liable for damages suffered from data loss, security breaches, or electrical problems. When complete, her Standard Terms serve two purposes: setting expectations and limiting her legal liability.

Teresa then outlines a couple more checklists to systematize typical repair operations, aiming to maximize successful repairs and minimize mistakes. These checklists also cover guidelines for disposing of drives and other tasks that could potentially result in harm to the customer.

Finally, Teresa realizes that even with these risk mitigation tasks complete, she should purchase some general liability insurance and possibly professional liability insurance as well. She gets quotes from several insurance brokers and chooses a package that offers both. With this insurance, Teresa feels confident that even if her shop does make a costly mistake, it will be covered. And with her solid intake and operations guidelines in place, she feels confident that her shop will not be likely to make those kinds of mistakes.

Find Out What Can Go Wrong

A good place to start your risk management program is to outline what the business is trying to protect—for example, your people, physical and financial assets, and reputation. Then you can move ahead to anticipating potential threats.

Liability Lurks All Around You

A sea of laws and regulations controls safety, land use, business, employment, and other matters that business owners must abide by—and ignorance of them is no excuse. You never know when you will be hauled up short for parking too many cars on the street, having an unsafe workplace, or causing an environmental disaster. You should have a pretty good idea, though, of the kinds of laws that apply to you, especially if you are in a heavily regulated industry, such as manufacturing, food preparation, or professional services. Harsh penalties (including prison time) can result if, for example, you fail to report a workplace death to the appropriate agency.

Finally, it should be no surprise that you can also get in trouble by breaking various criminal laws. Businesses traditionally have special problems with failing to pay taxes; with property crimes such as theft, fraud, and arson; and with antitrust laws that prohibit forming monopolies.

In addition to general risks, find out what can go wrong in your field. Talking with an insurance agent who is familiar with your type of business is one of the best ways to assess the possible risks you face. Talking with people who own or work in similar businesses is also useful, especially outside your local area; if they don't compete with you, it's more likely you can trust what they tell you. Reading trade magazines and websites will keep you abreast of the kinds of lawsuits being brought. And, finally, ask your employees what risks they see and what problems are waiting to happen. They may be one of your best sources for ideas to prevent problems.

Focus on Prevention

Once you've identified the main ways that your business is vulnerable, you should brainstorm ways to protect against these risks.

Setting a Solid Foundation

Most obviously, you should choose your partners, lenders, landlords, business sites, vendors, agents, and employees carefully. In particular, investigate in depth any deal that seems too good to be true—including the sales pitches of people who encourage you to set up in a franchise or buy expensive equipment.

Next, if you will be a joint owner of the business, get a clear understanding with your co-owners about all aspects of your business: what you want to accomplish, what you expect from one another, and how or when you might split up or buy out

a co-owner. Agreements known as buy-sell agreements outline how the business will handle transfers of ownership. (Buy-sell agreements are discussed in Chapter 15.) Money is usually the first big issue; control is next. It's essential to have your business formation agreement in writing, whether it's a simple one-page partnership agreement or a detailed operating agreement for an LLC. If possible, co-owners should agree to mediate disputes. Mediation is generally quicker, simpler, and cheaper than a lawsuit, which is why the business community has adopted it enthusiastically.

It goes without saying that you should operate your business on the up-and-up. That includes:

- filing all the required papers and getting the right permits
- telling the truth on all documents and to everyone with whom you deal
- keeping track of company funds, inventory, and important documents
- paying your debts
- delivering what you promise
- observing business formalities, such as keeping your personal money separate from business accounts
- putting important agreements into written contracts
- maintaining safety standards, and
- complying with all applicable laws, especially by paying your income and payroll taxes quarterly.

Owners must make sure their businesses comply with bureaucratic requirements. Applying for permits and licenses, filing reports, paying taxes, and so on are necessary evils for all businesses, and failing to do these things may, in some cases, expose the owners to personal liability. (Permits, licenses, and other bureaucratic hurdles are covered in detail in Chapter 7.) Even if a manager or another employee is in charge of filling out and filing the paperwork, ultimately it's your responsibility as an owner to make sure your business is in compliance. Check in regularly to make sure that paperwork is getting done.

Risk management can affect your decisions about what your business actually does. You might need to change or eliminate certain activities that are uninsurable or too risky. What is too risky can depend on the law and the availability of insurance in your state—especially for construction, manufacturing, and professional services.

Implementing Procedures and Checklists

Particularly if you can identify one or more risks in your business, you should have procedures in place in case one of those foreseeable incidents occurs. If there's a likely risk of customer injuries on your premises (as would be the case of an ice rink with lots of new skaters,

including young children), or employee injuries (for example, if you run a photo lab where injuries might result from chemical exposure), you should have clear procedures on how to handle any injuries that occur. Failing to have a plan in place for foreseeable accidents isn't just irresponsible: It raises the likelihood that any such accidents might be worsened by your poor response. And it increases the chances that your business could face a lawsuit for damages.

Put procedures in writing, and don't make them overcomplicated. Simple checklists can be extremely effective. For example, the ice rink in the example above should consider preparing a checklist of "yes/no" questions for employees to use when a skater is injured. Your checklist should help ice rink employees answer an initial question about what constitutes a true injury and not just a painful fall. If the checklist helps determine that a fall does qualify as a true injury, the ice rink should have another procedure or flowchart of actions to be taken, such as determining whether the skater is conscious, and if not, calling 911; or if the skater is conscious, asking the skater if they can recite their name and address. The flowchart should identify further steps to minimize the injury (such as putting ice on a swollen foot) and streamline the process of getting medical attention promptly.

Besides having procedures in place, it's obviously important to train the appropriate staff in how to implement them. Depending on lots of factors, you might decide to train all staff, or just train department managers and give them the responsibility to train staff on the procedures.

A few simple checklists, step-by-step procedures, and flowcharts kept in a slim binder with enough copies for key staff and managers (accompanied by appropriate training) can make a huge difference in protecting your business from a lawsuit. Injured customers or employees who know that a system is in place to take care of them might be less likely to feel your business is to blame for their injury and therefore might be less likely to sue. And if they do sue, being able to show that you swiftly executed your well-thought-out procedures will go a long way in lowering your liability for injuries or damages.

Getting Additional Information

If you are unsure what your employment policies should be and what laws you must follow, search for "Employment Law Assistance" on the U.S. Department of Labor website (www.dol.gov) and your own state's department of labor. You can also consult a personnel specialist or HR manager, or review other employers' personnel manuals to see what's covered. Nolo (www.nolo.com) also provides good free information online.

Nolo Resources on Employment Law Matters

Nolo's website offers many useful articles on subjects covered in this chapter, including discrimination and drug testing. In addition to the articles, Nolo publishes comprehensive employment law books for small businesses on the following subjects:

- **In-depth information about employment matters, including drug testing and privacy issues, employers' potential liabilities, and employee lawsuits.** *The Employer's Legal Handbook*, by Fred S. Steingold; *Dealing With Problem Employees: A Legal Guide*, by Lisa Guerin and Amy DelPo; *The Essential Guide to Federal Employment Laws*, by Lisa Guerin and Sachi Clements; and *Create Your Own Employee Handbook: A Legal & Practical Guide for Employers*, by Sachi Clements.
- **Sexual harassment and illegal discrimination in the workplace.** *The Essential Guide to Handling Workplace Harassment & Discrimination*, by Deborah C. England.
- **Workers' compensation laws and disability insurance.** *The Employer's Legal Handbook*, by Fred S. Steingold.

Workplace safety issues can be addressed through training programs and posted materials. You can ask consultants who know your type of business to evaluate your workplace for compliance with the Occupational Safety and Health Administration (OSHA)—the agency that establishes and oversees workplace safety standards. Workplace safety will be an ongoing consideration and expense.

Beyond establishing and communicating personnel and other policies, your business needs to have enforcement mechanisms in place. The toughest written sexual harassment or safety policy won't protect a business from a major lawsuit if there's no one to complain to who has power to change the situation, or if complaints go uninvestigated and policies unenforced.

An "open door" policy and a safe channel to launch complaints are very helpful. Employees who understand that their employer is taking care of their concerns are less likely to become frustrated and sue.

In many states, you can ask the employee to agree to refer serious issues to a mediator and then, if they can't be resolved within a reasonable time, to an arbitrator. A mediator is someone who helps people come to an agreement, while an arbitrator makes a binding decision. Some states automatically refer civil lawsuits to a mediator to see if the parties can settle before a judge will hear the case. Many employers have such an agreement in their personnel manuals that every new employee reads and signs.

It helps morale if the employer pays the costs of mediation and arbitration. After all, the employee probably has very little spare money, and a one-day mediation can commonly cost anywhere from $500 to $3,000. Some community mediation groups will take on small business claims for free or a nominal cost.



CAUTION

A lawsuit may still be possible. Agreements between employers and employees that make arbitration the employee's exclusive remedy are not always binding. Judges do not like to see employees give up their rights to complain to government agencies or to bring lawsuits, especially if the employee has to agree to arbitrate future disputes as a nonnegotiable condition of employment, such as in a written employment contract. The law in this area is changing rapidly, so you should find out what is legal in your own state. For a good short discussion of mandatory arbitration, see *The Employer's Legal Handbook,* by Fred S. Steingold (Nolo).

Deal With Problems

When a problem does arise, stay as calm as possible while you get as much information as you need to decide what to do. You won't do yourself or your business any good with an unconsidered response.

If a problem comes up in an area that is addressed in a written contract, a calm meeting or phone call is a good idea, followed up by a letter summarizing the meeting or conversation. Any meeting with a problem employee should be witnessed by at least one person who is neutral. If you are out of your depth, contact an expert such as an accountant, a lawyer, a doctor, an employment law specialist, or a mediator. Keep employment matters confidential.

Finally, realize that you might end up paying something to settle a claim or to defend yourself, whether or not you feel responsible for what went wrong. Owners of sole proprietorships and partnerships are personally liable for all business debts, including damages stemming from a lawsuit against the business. It doesn't matter much whether these owners are personally named or found liable in a lawsuit, or whether only the business itself is—either way, they'll be personally responsible for paying the damages. This fundamental rule regarding sole proprietorships and partnerships is a major reason why many business owners choose to create an LLC or a corporation.

If your small business is an LLC or a corporation (or if you are a limited partner in the business), then you, and owners

like you, will ordinarily not be personally responsible for any damage awards against the business. Only business assets can be used to satisfy those debts. Of course, that could wipe out your business.



CAUTION

Personal guarantees may bind you. As a practical matter, most suppliers and banks require a personal guarantee from small business owners on contracts and loans. This means that there will be personal, individual liability on claims arising from those contracts. Similarly, business owners will personally sign the document that creates their business, so the co-owners can sue one another personally on claims that arise out of starting, running, or winding up the business.

Paying for What Goes Wrong

If you have been prudent, and if the business is reasonably successful, there will be some extra money in the bank for emergencies. You might have some business assets, such as machinery or a building or inventory, that you can sell or pledge to raise money—subject, of course, to agreement by your co-owners. You might also have some insurance that applies. An insurance company has to pay for an attorney to defend you against a claim your policy covers. It will likely also pay some, maybe most, of any eventual settlement or judgment against you if the claim is covered by your policy. (Insurance is discussed in more detail below.)

All business owners—even owners of corporations and LLCs—may face personal liability in certain situations. Those who recklessly or intentionally cause harm may be found personally liable for injuries caused by their actions. The same is true for business owners who don't carefully investigate a deal before making a business decision.

Insurance and Warranties

Insurance coverage is a powerful tool in risk management. However, you won't be required to obtain property or liability insurance for your business unless:

- your state requires liability insurance for a company vehicle
- state and federal law requires it because you have employees
- a contract job (usually with a government agency) requires the contractor (your company) to have a certain amount of insurance, or
- your lender requires it as a condition for getting a loan.

But just because you don't have to get insurance doesn't mean you shouldn't. Even if you form a corporation or an LLC, which shields your personal assets from business liabilities, it won't protect you from losing your business if disaster strikes. Careful as you may be, fate sometimes deals an unforeseen blow. If you face unexpected trouble, you'll be thankful you've taken steps to protect yourself.



CAUTION

Employers are subject to special insurance requirements. Employers must typically pay for workers' compensation insurance and unemployment insurance. A handful of states also require employers to pay into a state disability insurance fund. All of these insurance programs are specifically set up for employers and are largely regulated by state agencies. (See Chapter 16 for some of the special rules governing employers' and employees' contributions to these insurance programs.)

There is an art to insuring your business: You want to get the maximum protection from insurance without blowing your whole bankroll on policies for every conceivable risk. Once you start to look, you'll find every imaginable type of insurance policy out there, although your business will probably need only a few of them at most. The two most common and generally useful types of policies are property insurance and liability insurance. This section will explain the basics of these and introduce you to many other kinds of policies that cover specific risks involved in your business. It will also shine some light on the process of shopping for and buying the policies you need.



TIP

Caring for your policy. Treat your insurance policy—either a digital or hard copy—just as the precious, and possibly irreplaceable, document that it is. Store it carefully. Keep an old policy even after you change insurance providers. A claim could come up that arises from a long-ago event, and that document may be your only way to track down an insurer that you had in the past. Believe it or not, if the insurance company or its successor is still in business and you have a copy of the old policy to prove it covered that event, the insurance company should provide the protection you paid for at the time.

Property Insurance

This chapter concentrates mostly on liability issues, but other types of losses can also be devastating to a business. Property insurance can cover your business for damages or loss to your business property due to theft, fire, or other enumerated causes. Policies vary a great deal as to the property and risks they cover, and how extensive the coverage is. Be sure you're absolutely clear on these terms when you choose a policy.

You'll want to make sure that your property insurance covers the premises themselves as well as the business's assets that are kept there, including:

- fixtures to the property, such as lighting systems or carpeting
- equipment and machinery
- office furniture
- computers, telephones, and other office machines, and
- inventory and supplies.

Some property insurance policies cover only the building and not the contents like equipment, furniture, fixtures and inventory (also known as "non-attached assets"). Often the former is called "commercial property insurance" and the latter is called "personal property insurance," even when the items are owned by your business, not by you personally.



TIP

If you rent your business space. Your lease might require you to get a specific amount or type of property coverage. Be sure to check your lease for any insurance requirements before you purchase a policy.

If you purchased your business property. You almost certainly paid for title insurance, which protects you from challenges to your ownership of the property. You might also want to purchase a life insurance policy that is dedicated to paying the mortgage if anything happens to you. You usually get the best deal if you buy this on your own, not from your mortgage lender or broker.

You'll need to understand not only which property is covered by your policy but what types of losses will be covered. Read it carefully to determine what causes of damage are insurable. Most general business property insurance policies will provide *basic*, *broad*, or *special* coverage—with special offering the broadest coverage and basic the narrowest.

A basic form policy will normally cover fire, explosions, storms, smoke, riots, vandalism, and sprinkler leaks. A broad form policy typically covers damage from broken windows and other structural glass, falling objects, and water damage. With both basic and broad form policies, certain risks might be listed as excluded—that is, not covered. Note that theft isn't typically covered under either a basic or broad form policy, a fact that surprises many business owners. (See "Theft Insurance," below.)

Special form coverage offers the widest range of protection, as it typically covers all risks—including theft—except for those risks that are specifically excluded. While premiums for special form policies are more expensive, it might be worth the added expense if your business faces unusual risks—or simply to make sure you're covered against theft.

A basic policy may not cover the other property that you have at your business premises—for instance, if you rent a laptop or other equipment, or if customers leave their goods with you as happens at a jeweler, dry cleaner, or repair shop. If you expect to regularly have property that belongs to others at your business, get a policy that covers it.

If the policy you are considering excludes one or more items that you want covered, find out whether it can be included and at what cost. You might have to purchase what's commonly called a "rider" or an "endorsement" to add special coverage to the policy. For example, accounting records, cash, and deeds are often excluded from standard property insurance policies but can usually be covered with some extra paperwork—and an additional premium.

You might find other ways to bring the property you want covered under the scope of the policy. For example, if you want the policy to cover your wireless speakers that you keep at the office, but the policy covers only business property, one option is to transfer title of the speakers to the business.

Be sure that you clearly understand the dollar limits on your policy and any deductibles or copayments you'll have to make. Also, buy a policy that covers the replacement cost of the property, not merely its depreciated value. Computer equipment, for example, loses value incredibly fast. If you lose your two-year-old computer to theft, you'll definitely want your insurance to pay for a new computer rather than the value of the stolen one, which might be barely enough to cover the shipping costs of a new machine.



CAUTION

Possible policy adjustments for home-based businesses. Owners of home-based businesses should figure out whether their homeowners' or renters' policies forbid business use of the home or exclude coverage of business-related claims. Make sure that your policy won't be limited or voided entirely by running a business out of your home. It's better to come clean with your insurance company about your home business and maybe spend some extra premium dollars than to find out after a catastrophe that you had no insurance after all.

Liability Insurance

Liability insurance will protect you against claims brought by third parties—someone who claims that your actions (or inaction) caused harm or loss. However, no policy will insure you against the consequences of bad business decisions, criminal acts, or intentional acts of harm. And note that liability insurance is "third party" only—it covers only other people who are injured as a result of your or your employees' negligence. It won't cover you. So if a customer slips and is injured on your wet floor, your liability policy would cover a claim; if you slip, your only recourse will be your personal health insurance policy (and if your employee slips, your workers' compensation policy should step up).

Liability coverage insures you against the notorious slip-and-fall situation, when someone gets injured on your premises and sues you for the ranch. A general liability policy (versus a product liability or vehicle liability policy, discussed below) will cover damages that your business is ordered to pay to an individual, such as a customer, supplier, or business associate who was injured on your property. It's very unwise to operate almost any business, even those that do not host the public, without this coverage, called "commercial general liability" (CGL for short). Note that CGL policies may not cover certain employment law claims such as harassment, discrimination, and wrongful termination, which are covered by employment practices liability insurance, discussed below.

Product Liability Insurance

Product liability insurance is related to personal liability insurance—it, too, covers injuries. But it comes into play when the injuries were caused by a product you made, sold, or provided. If your business has a product that has a risk of harming anyone, no matter how far-fetched, you might consider this type of insurance. Plaintiffs have won product liability lawsuits even when they were ignoring warnings or misusing products. An insurance premium will be less expensive than a big award (or even a settlement) to a tragically injured plaintiff.

Auto Insurance

Auto liability coverage will not be provided by a general business liability policy, but it is legally required in most states. Even if it's not required in your state, it's foolish not to protect yourself against this potentially devastating risk. Insurance coverage for employees' personal cars that are used for business is known as "nonowned auto" liability insurance. This protects your business if an employee hurts someone or damages property while driving their car on the job. If your employees will use their own cars for business activities, it's important that you get this type of coverage even if your state doesn't require it. Nonowned auto liability insurance policies typically cover damage to other vehicles and medical costs for injuries to third parties. Any damages to the employee's vehicle are typically excluded from coverage, as are medical bills if the employee is injured.

In addition, some states require drivers to be covered by other types of auto insurance, including personal injury protection (PIP) coverage and uninsured/underinsured motorist (UM/UIM) coverage. If your state mandates certain types of coverage, it will generally also require that you purchase a minimum level of the insurance. Check with your state's department of motor vehicles to find out insurance requirements for drivers in your state.

Specialized Insurance

Property and liability insurance are the two most important types of coverage for small businesses, but there are many other kinds of policies. Some of the more common ones are listed below. Keep in mind that a broad property or liability policy might already cover one or more risks listed here. For instance, if you have special form property insurance (discussed above), you'll probably be insured against theft.

Employment Practices Liability Insurance

This is a relatively new kind of insurance. It can protect you against a number of employee claims including harassment, discrimination, and wrongful termination. It can be a very useful supplement to commercial general liability insurance.

Business Interruption Insurance

This type of insurance will cover you if your business is forced to close for a period of time for a reason covered under the policy, such as damage from a fire or an earthquake. In that case, your policy will pay approximately what you would have earned if you had been open as normal. Note that, in many cases, businesses that have shuttered due to COVID have been denied payouts from their business interruption insurance because COVID was not included in the policy as an allowable trigger.

"Key Man" Insurance

Key man insurance is a life insurance policy that the business owns, pays for, and collects on. It protects the business when a crucial person dies and the business grinds to a halt. The "key" person whose life is insured can be the founder, the owner, or an employee—the person who knows everything and holds things together, especially in a small business. This insurance gives the business some extra cash that buys time to decide what to do: whether to hire a replacement, sell the business as a going concern, or wind down gracefully. It is similar in effect to business interruption insurance.

Professional Liability Insurance

This type of insurance protects you from lawsuits arising from professional mistakes. Doctors, lawyers, real estate agents, accountants, consultants, and a number of other professionals use professional liability insurance to protect them from claims that their advice resulted in financial loss or personal injury. It is also known as "errors and omissions" (E & O) or "malpractice" insurance.

Theft Insurance

Because many basic policies do not cover losses due to theft, you might want to purchase theft insurance to cover you in case office equipment is stolen. Find out whether the policy covers employee theft as well as ordinary burglary and robbery. If not, you can usually purchase that type of coverage separately.

Special Coverage

Other types of insurance include credit insurance for accounts receivable, insurance for intellectual property, such as trade secrets or patents, and disability insurance for owners of the business. (This is not the same as state-mandated disability insurance for employees, discussed in Chapter 16.) Some businesses need insurance for issues that arise out of advertising, while others might need to guard against a big bill for environmental cleanup of purchased real estate. If you are an importer and travel frequently to dangerous foreign locations, you might want kidnap and ransom insurance. Talk with an insurance agent or broker about whether your business activities might warrant one or more of these special types of coverage.

Many corporations have special liability insurance called "directors' and officers'" (D & O) insurance, because there are occasions when directors and officers are sued individually for making employment and other decisions. This comes up, for example, in sexual harassment cases. An insurance agent can tell you when a small corporation needs this type of coverage.

Investigating and Purchasing a Policy

You have to do your homework to make an intelligent and cost-effective insurance purchase. You must understand both the large and fine print so you can compare policies and purchase the best one for your business. For example, when comparison shopping among different insurance companies, it's useless to compare two policies unless they cover the same types of property, the same risks, and the same payouts and deductibles. You can't make an informed decision until you understand all these details.

Insurance brokers, who gather information from different insurance companies, can help you decipher policies and figure out your best deal. Any broker you consult should understand all the nooks and

crannies of your business activities and the risks that are involved. Try to find one who specializes in policies for your type of business. You might be surprised to learn that specially tailored policies already exist that cover your particular needs. For instance, a "producer's package policy" for filmmakers covers several risks unique to the film business, such as the costs of production—often in the tens or hundreds of thousands of dollars—in case of lost or destroyed film or digital media. An insurance broker who knows your type of business will be able to direct you to these specialized policies, while a run-of-the-mill broker might not.

Check trade magazines and websites for the ads of specialized brokers, and ask other business owners whom they use and what they buy.

You'll probably encounter insurance companies that offer package deals that are cheaper than buying several individual policies separately. As long as all your needs are met—and not exceeded—these deals can be a good way to go. As always, be sure you understand the extent of coverage in each area rather than relying on any general promises that the package covers "all your business needs."



RESOURCE

Finding help with business insurance on the internet. A couple of websites that may be helpful are www.irmi.com, the website of the International Risk Management Institute, and the Insurance Information Institute's website at www.iii.org.

Manufacturer's and Extended Warranties

While insurance can protect you when property is damaged or stolen, product warranties can protect you in case equipment malfunctions for various reasons. Don't overlook the value of warranties when considering ways to reduce risks and potential losses related to your equipment.

Most products come with a standard manufacturer's warranty against defects for a certain period of time. Warranties generally range from 90 days to one year of coverage. It's not uncommon for the warranty to cover parts and labor for different time periods—for example, parts might be covered for one year, and labor for 90 days.

In addition, you can purchase extended warranties for most equipment that offer coverage for longer periods, generally from two to five years. Though some manufacturers offer extended warranties to supplement the standard manufacturer's warranty, many extended warranties are sold by companies other than the manufacturer. These companies make big profit margins on extended warranties, leading many consumer advocates, including *Consumer Reports* magazine (in an April 2018 online article), to generally advise people against purchasing extended warranties.

The truth is, in some situations it will make sense for you to purchase an extended warranty. Generally speaking, the more expensive and important a piece of equipment is to your business, the more an extended warranty might be a smart idea. For example, if your business cannot live without a certain piece of equipment such as a computer, and would be financially hard-pressed to replace it if it went south, an extended warranty might be a godsend—but always account for the repair time during which you won't be able to use the equipment.

When considering whether to buy an extended warranty, consider the following factors.

Be clear about when the extended warranty coverage begins and how long it lasts. In particular, don't pay for extended coverage that overlaps with the original manufacturer's warranty. If coverage begins as of the date of purchase of the extended warranty, as opposed to the date of purchase of the equipment, wait until the original warranty is about to expire before purchasing the extended warranty. Most warranty companies allow this—but be aware that you will usually not be able to purchase an extended warranty if the original warranty has expired. Find out in advance what deadlines apply to the extended warranty purchase.

Make sure you trust the warranty company. Particularly if the warranty is being sold by a third-party warranty company, evaluate the reputation and reliability of that company. If the extended warranty is sold through a major national retailer, chances are it is not a fly-by-night scam—though it still might not be worthwhile. But be aware that scam warranty companies do exist.

Evaluate the value of the extended coverage. Weigh the cost of the extended warranty and what it will cover against the cost of the equipment and the likelihood it will need repair. Just as with insurance, warranties generally exclude certain types of damage from coverage. The more limitations on coverage, the lower the value of the warranty.

When you do have warranty protection, whether from an original manufacturer's warranty or an extended warranty, it's crucial to keep track of important warranty details—especially the expiration dates, so that you can purchase extended coverage if you choose. As mentioned above, you will usually not be allowed to purchase an extended warranty if the original or previous extended warranty has expired—so be careful not to let those important dates slip by if you intend to purchase extended coverage.



FORM

Warranty Track Worksheet. The Nolo website includes a downloadable interactive worksheet to help you track your warranty information. See the Appendix for the link to this worksheet and other forms in this book.

Simply enter all relevant information into the worksheet about warranty coverage for every piece of business equipment you buy. If you don't have information for every column, it's okay, but be sure to include the warranty expiration date. Keep the list sorted by "Warranty Expiration Date" (Column C) in ascending order, so that the warranties about to expire will be at the top of the list. Make it a habit to enter this information as soon as you purchase any equipment, and to review and update the worksheet periodically so that you don't miss any expiration dates and the chance to purchase extended coverage.

Chapter 8 Checklist: Risk Management

- ☐ Have active risk management strategies. Start by evaluating your risks and identifying specific ways to reduce them.
- ☐ If your business has employees, establish personnel policies, including hiring and firing guidelines, policies prohibiting sexual harassment and discrimination, and effective enforcement mechanisms.
- ☐ Research and purchase appropriate insurance for your business. Contact an insurance agent or broker familiar with your business to answer your questions and to price out various policies.
- ☐ Get a property insurance policy that covers against all the types of losses that your business may face, such as theft, fire, and water damage.
- ☐ Get a liability insurance policy if your business will have any contact with the general public, or if you determine there's a significant risk that someone could sue your business for injuries or other damages.
- ☐ Get auto liability coverage for any vehicles used for business, including the personal cars of employees that they use for business.
- ☐ Consider other, specialized insurance coverage.

CHAPTER 9

Paying Your Taxes

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It's no fun for any profitable business to share its hard-won earnings with the government. But, like it or not, as soon as your business is in the black, everyone—from your city and county to your state and, of course, the United States Internal Revenue Service (IRS)—will demand a piece of the action. Although it's not necessary to become a tax expert before going into business, you do need to know what taxes you'll have to pay and how to pay them. Understanding your tax liability will help you be better able to:

- plan your finances, including whether you'll have enough cash to stay in business
- avoid tax-reporting and deposit errors, which can result in hefty penalties, and
- make good business decisions that will reduce your tax burden.

Lots of new businesspeople believe that if a business doesn't make a profit, it owes no tax. Sadly, this is not the case. Local taxes on gross receipts and taxes on sales of retail goods (sales taxes) are but two examples of taxes that you might need to pay regardless of whether a business is turning a profit. So, even if your business isn't profitable for a year or two, you need to prepare for the possibility of owing some taxes.

This chapter gives you simple, straightforward information on the taxes that owners of sole proprietorships, partnerships, and LLCs will face. It provides basic instructions for filing returns and paying taxes correctly and on time. After covering the basics, it offers three sections that discuss the specific tax rules that apply to each business type—sole proprietorships, partnerships, and LLCs. Simply read the section that's appropriate for your business form and skip the others. The last three sections cover paying estimated taxes, local taxes, and sales taxes—all of which apply more or less evenly to all business types. If your business is home based, see the section on home business tax deductions in Chapter 10, "Laws, Taxes, and Other Issues for Home Businesses." If your business has employees, refer to Chapter 16, "Building Your Business and Hiring Workers," for information on the special taxes employers face.



RESOURCE

Help with corporate taxation. This chapter offers only a broad outline of corporate taxation. The full maze of corporate tax rules is far too complicated to cover in detail here. If you're thinking about incorporating, keep in mind that doing so will subject you to more complicated (and occasionally unpleasant) tax rules. See the "Corporations" section, in Chapter 1, for an overview of the potential tax advantages and disadvantages of corporations. If you need more detailed information, take a look at *Tax Savvy for Small Business*, by Frederick W. Daily (Nolo).



SEE AN EXPERT

Having an accountant handle your federal and state taxes is almost always well worth the expense—especially after 2017's major tax law changes. The Tax Cuts and Jobs Act includes many changes to allowable deductions, how business losses can be claimed, and more. It's especially important to use a tax preparer who understands this law. While it's wise to learn the basics as outlined in this chapter, it's almost always a good idea to turn over the task of preparing federal and state income tax returns to a professional accountant. If you have well-organized records (see Chapter 12, on bookkeeping), annual tax prep for a small to medium-sized business will probably cost less than $1,000. For really small operations it might be even less than $500. Considering the importance of competent tax preparation, you should accept early on that this is an unavoidable cost of running any business. (See Chapter 17 for advice on finding and working with professionals like accountants.)

Tax Basics

One of the first things you should understand is that there's little rhyme or reason to the world of taxes. Don't drive yourself nuts by trying to figure out the logic of a system that has virtually none. The bottom line is that the federal, state, and local governments tend to tax everything that they legally can. And their targets include virtually every aspect of a business that can be quantified. For example, depending on the type of business and its location, a business might have to pay taxes based on its gross income, net profit, or gross retail sales; how many employees it has; how much employees are paid; how much property it owns or leases; its seating capacity; or how many vehicles the business owns—and the list goes on and on.

To complicate matters further, the many taxes are administered by different government agencies, each with its own rules, forms, and filing procedures. It's little wonder that the mere mention of taxes often induces anxiety and sometimes even panic in otherwise well-adjusted businesspeople.

The Agencies Behind the Taxes

The first step in understanding small business taxes is to recognize who levies which taxes. Here's a quick breakdown:

- **Federal taxes.** The IRS, the top dog of tax agencies, collects the following taxes from small businesses and their owners: taxes on individual or corporate income, self-employment taxes (which go to the Social Security and Medicare systems), and payroll taxes. (See "Special Hurdles for Employers," in Chapter 16, for information on payroll taxes.)

Talking About Income—Key Terms Defined

A lot of different jargon describes the money that comes into and flows out of your business. These financial terms are discussed in more detail elsewhere in the book, where we cover financial projections and accounting. (See Chapters 4 and 12.) Because these concepts are also important in understanding your taxes, here are some brief definitions:

- **Gross versus net.** It's crucial to understand this distinction. "Gross" generally refers to total revenue, before deducting expenses such as salaries, rent, product costs, or office supplies. "Net" means what's left over after subtracting costs and expenses. (As you can see, a gross figure will be higher than a net figure, because deductions come out of the gross and result in the net.) Thus, gross income (sometimes called gross receipts or gross sales) refers to the total money your business brings in, before you've begun to cover any of your costs. Net profit refers to your income after deducting costs and expenses. In some contexts, "net" might refer to your after-tax profit. In other words, it might reflect not only your costs and expenses, but also any taxes you owe on your income. Be aware that the terms gross and net are often bandied about loosely. It's important to understand which deductions are included when using these terms.
- **Fixed versus variable expenses.** Fixed expenses are the ones that will be more or less the same regardless of how well your business is doing. They include rent, utility bills, insurance premiums, and loan payments. Variable expenses are the costs of the products or services themselves and anything that goes along with your product, including packaging or shipping. Variable expenses increase or decrease depending on how much business you're doing.
- **Gross profit.** Gross profit refers to how much money you make on each sale above the cost of the item itself (its variable cost). Unlike the term "gross income," which refers to all the money your business brings in before expenses are accounted for, the term "gross profit" does take into account the cost of the product or service you're selling. For example, if a widget costs you $3 and you sell it for $5, your gross profit is $2. The terms "profit margin" or "gross margin" are sometimes used to mean the same thing. The key thing to remember about gross profit is that fixed expenses such as rent or utility bills are not deducted—only the cost of the product or service itself.
- **Net profit.** This is what's left over after subtracting fixed expenses from gross profit. Put another way, net profit means the amount of money you have left over after subtracting all expenses—fixed and variable—from your gross income. Sometimes the term "net income" is used to mean the same thing as net profit.

Talking About Income—Key Terms Defined (continued)

- **Current versus capital expenses.** Current expenses include ordinary, day-to-day business expenses, such as office supplies or salaries. For tax purposes, you can deduct them from your business income in the year that you pay for them. Capital expenses, on the other hand, include payments for business assets (also called "capital," "fixed," or "depreciable" assets) that have a useful life of one year or more, such as computers or office furniture. Capital expenses generally can't be fully deducted in the year they are incurred but must be deducted over a number of years—a process known as depreciation, capitalization, or amortization. (In practice, there are ways to fully deduct capital expenses in the first year of use, which we discuss later in this chapter.)

- **State taxes.** States typically collect the following taxes from businesses and their owners: taxes on individual or corporate income, sales taxes on sales of retail goods and sometimes services (usually called "sales taxes" but sometimes "gross receipts taxes"), and payroll taxes. States also often collect special taxes (called "excise taxes") on certain types of business activities such as distributing alcohol, cigarettes, or gasoline. In addition, some states collect taxes on LLCs and limited partnerships.
- **County and city taxes.** Cities, counties, or sometimes both typically impose taxes on businesses based on several factors. Most cities assign businesses to categories (for example, retail businesses, wholesalers, and services) and then tax each category based on certain criteria, such as gross receipts, gross payroll, or number of employees. In addition, counties often assess and collect property taxes on real and personal property owned by businesses within the county (and commercial landlords often pass some of these taxes onto their tenants). Cities and counties also may impose a sales tax, which the state may collect along with the state sales tax.



CAUTION

A tax by any other name is … a fee. In addition to the taxes listed above, your business might have to pay fees for business licenses or tax registration. For instance, many cities and counties require all businesses in the area to register with the local tax collector and pay a registration fee. And, if your business needs to obtain a special license, such as a permit to handle food or a cosmetology license, you'll usually have to pay for it. While these fees arguably could be called taxes, this chapter does not deal with them as such. The various registration, permit, and license requirements—including their associated fees—are covered in Chapter 7.

Forms and Schedules and Returns, Oh My!

This chapter makes many mentions of tax forms, tax schedules, and tax returns. Basically, these are simply different names for the forms you have to fill out and submit to your federal, state, and local tax agencies.

Technically, a "tax form" is the principal document that businesses and their owners must use to report all the basic information about the business's or individual's income. For instance, every individual who earns income must fill out Form 1040, *U.S. Individual Income Tax Return*, and all partnerships and LLCs must file Form 1065, *U.S. Return of Partnership Income*.

A "schedule" is an additional sheet of information the IRS requires businesses and business owners to attach to their tax forms. For instance, sole proprietors must submit Schedule C with their Form 1040 to report their income from their business, and partners and LLC owners usually need to report their business income on Schedule E. Partnerships and LLCs also must include various schedules with their Form 1065s.

Finally, a "tax return" is simply a general term for the whole package you send off to the IRS: your tax form, any schedules, and any attached documents.

Understanding Deductions

Increasing profits while keeping taxes as low as possible is the name of the game in any business. The main way to do this is by claiming business deductions. When you deduct an expense, you subtract it from your taxable income—which means you'll have less income to report and pay taxes on. Of course, you can't deduct just any old expense. To stay out of tax trouble, you need to know which deductions are allowed and which are not. (Note that deductions are often irrelevant for local and sales taxes, which tend to be based on gross income—also called "gross receipts"—without taking any deductions into account.)

What Expenses Are Deductible?

Allowable deductions are outlined at great length (to put it mildly) in the Internal Revenue Code—although the basic guidelines are summarized here below. You'll need to follow these rules when filling out your federal tax return, which you use to report your business income and deductions. When you file your state income tax return, you'll generally fill out a form that uses the information from your federal return, with a few adjustments to reflect your state's rules on deducting business expenses. As far as local taxes go, they might simply be based on gross income (also called "gross receipts") without taking any deductions into account. Your main concern should be the federal rules.

The Section 179 Deduction

The IRS allows every business to treat a certain amount of capital expenditures as current expenses and fully deduct them in the year they were made. This major exception is known as a "179 deduction," because it's established in Internal Revenue Code § 179.

Tax law changes since 2003 dramatically increased the limit from $25,000 in 2003 to $250,000 in 2009—and federal stimulus legislation doubled the limit to $500,000 for tax year 2010. Between 2010 and 2015, the limit bounced up and down as legislation expired and was renewed; then the Tax Cuts and Jobs Act of 2017 set the limit at $1 million for tax years 2018 and beyond. Since 2018, the limit has been indexed to inflation. This allows businesses to write off, up to the current year limit, expenditures that normally would have qualified as capital expenditures.

Whether and to what extent you should take advantage of a 179 deduction depend on your circumstances. Generally, you should take a 179 deduction only when your taxable income is high enough that you'll get a decent tax benefit right away. Businesses with low incomes might want to depreciate assets instead (take their deductions slowly) so that they'll have more deductions available in future years when their income might be higher.

The Internal Revenue Code (IRC) states that any "ordinary and necessary" business expenses can be subtracted from your business income for federal tax purposes. (IRC § 162.) Figuring out whether most expenses qualify is a no-brainer. Product costs, office rent, equipment and machinery, office supplies, your business computer system, business insurance, salaries, payroll taxes, and office utility bills are just a few examples of costs that easily count as deductible expenses. As long as an expenditure is, in fact, made for business—not personal—purposes, the general rule is that you can deduct it from your business's gross income.

It gets a little more complicated when expenditures aren't clearly made for business reasons. The IRS has special rules for expenses that border on the personal, such as travel, and vehicle expenses. These costs are deductible, but only according to special IRS rules (for details, see IRS Publication 535, *Business Expenses*, available online at www.irs.gov).

How Are Expenses Deducted?

In addition to figuring out whether an expense is deductible, you need to understand how particular expenses may be deducted. First, you need to know that there's a major distinction between current and capital expenses. Current expenses can best be described as your everyday costs of doing business, such as rent, supplies, utility bills, and the like. These expenses are fully deductible in the year they occur.

Capital expenses, on the other hand, are not fully deductible in the year you incur them. You incur a capital expense when you purchase an item with a useful life of at least one year—called a "business asset." Business assets include items such as vehicles, furniture, heavy equipment (like a forklift or printing press), and real estate.

Rather than fully deducting a capital expense in the year it was made, you must spread out the deduction over a number of years. (A major exception to this, the 179 deduction, is discussed above.) This process is variously called "depreciation," "amortization," or "capitalization." Different types of assets have different depreciation rules, and the number of years over which the cost of an item must be depreciated varies. Depreciation rules are explained in IRS Publication 946, *How to Depreciate Property*, available online at www.irs.gov, as well as in other IRS publications that cover specific types of assets.

Note also that start-up expenses—those incurred before you actually launched your business—are subject to special tax rules. The general rule is that businesses may write off up to $5,000 of their start-up costs in the first year of business, as long as start-up costs do not exceed $50,000. The $5,000 deduction is reduced by the amount of your start-up costs that exceed $50,000. Whatever you are unable to deduct, you can amortize—a process in which you stretch out the deduction over time. Start-up costs that can't be deducted outright are amortized over the next 15 years.

Where to Get Tax Forms and Schedules

Besides the flood of tax forms that are available at libraries as April 15 comes near, you can obtain the most current tax forms, schedules, and publications by ordering them over the phone or downloading them from the IRS website:

- Download federal tax forms and other publications from the IRS website, including IRS Publication 535, *Business Expenses*, at www.irs.gov. If you'd prefer to have them mailed to you, call the IRS at 800-TAX-FORM.
- For state tax forms, contact your state tax agency.
- Local tax forms and instructions are often automatically sent to businesses once they've registered with their city or county. Otherwise, contact the agency in charge of business taxes in your city or county (depending on where your business is located) for more information on how to obtain local tax forms. To find your local tax agency, look in the city and county government sections of your telephone book under "Tax Collector," "Business Tax Division," or "City Clerk," or check your city or county website.



RESOURCE

Learn more about tax deductions. This introduction to tax deductions only begins to scratch the surface of a huge and complex body of information. *Deduct It! Lower Your Small Business Taxes,* by Stephen Fishman (Nolo), does an excellent job of leading you through the maze and includes detailed advice on how to write off your start-up costs.



SEE AN EXPERT

Consider working with a tax expert. Especially as your business grows and its finances become more complicated, you may well want to hire a tax adviser to help you use the tax rules to your best advantage. (See Chapter 17 on hiring and working with tax professionals.)

Hobby Businesses

For many small business owners, their "business" is more a labor of love than a reliable source of income. This is most often the case when an owner has other means of financial support—such as a regular job or a spouse who brings home wages or other income—that allows a microbusiness to continue even though it makes little or no money. These types of tiny businesses are usually operated from the home and are often based on activities near and dear to the owner, which has earned them the nickname "hobby businesses."

There is no one type. Examples of hobby businesses might include a basement jewelry studio, a jazz band for hire, or an antique refinishing business. The owners would probably keep on making jewelry, playing jazz, or restoring antiques even if they never made a penny, but are trying to turn their hobbies into profitable businesses.

Often, profits fail to materialize. For most regular businesses, spending more than a year or so of losing money is a cue to close up shop. But if you love what you're doing, it might make sense for you to stick with your losing business rather than fold it up. This is true because if you have another source of income (as many owners of hobby businesses do), the losses from your hobby business can be used to offset that income. Deducting business losses—including everyday expenses and depreciation on assets such as computer equipment—not only lowers the amount of income on which taxes are calculated, but also may drop you into a lower tax bracket. This is what is commonly referred to as a tax shelter: an unprofitable business whose losses offset the owner's taxable income from other sources.

Of course, most entrepreneurs would much rather earn a healthy profit than lose money. And the savings made possible by a tax shelter do not always justify continuing a marginal or losing

business. But they definitely can make a difference in deciding whether it's worth it to keep your unprofitable—but enjoyable—business going.

EXAMPLE: Kay and Reza are married and file joint tax returns. Reza earns a salary as a chef in a local restaurant, and Kay is a magazine editor. Kay has a passion for plants and decides to try to make a business of selling some of the hundreds of plants she grows in her backyard greenhouse. After she's spent thousands of dollars on exotic plants and better lighting, the greenhouse heater goes on the fritz and more than 300 of Kay's expensive, exotic plants die. Her expenses for the year total nearly $10,000, and she has not yet sold any plants. The silver lining for Kay and Reza comes at tax time, when they deduct the $10,000 loss from their joint taxable income of $105,000. This not only reduces their taxable income, but—depending on their income level and any other deductions they take—might drop them into a lower tax bracket as well.

On the downside, if you consistently use your unprofitable business as a tax shelter, deducting your losses from your other income year after year, you'll probably attract the attention of the IRS. An issue that often arises with hobby businesses is whether the venture is really a business at all. To deduct expenses from your taxable income, those expenses must have been incurred by a legitimate profit-motivated business—not merely a personal hobby. As you might expect, not every hobby counts as a business. If you claim a loss from your hobby business and you're audited, you'll have to prove to the IRS that your hobby is in fact a legitimate business.

Proving Your Hobby Is a Business

Before you start claiming deductions for the costs of your favorite art projects or toy car collections, make sure your venture will pass IRS scrutiny and qualify as a real business. Thankfully, the IRS's definition is broad. Basically, any activity that you undertake to make a profit counts as a business. You need only prove to the IRS that you're trying—not necessarily succeeding—to make a profit with your venture. The IRS uses a few criteria to decide whether your business truly has a profit motive.

The main test for profit motive is called the "3-of-5" test. If your business makes a profit in three out of five consecutive years, it is legally presumed to have a profit motive.

While the IRS gives a lot of weight to the 3-of-5 test, it is not conclusive. In other words, if you flunk the 3-of-5 test, you still might be able to prove that your business is motivated by profit. You can use virtually any kind of evidence to prove this. Business cards, a well-maintained set of books, a separate business bank account, current business licenses and permits, and proof of advertising will all help to persuade an IRS auditor that your activity really is a business.

Watch Out for Local Tax Rules

When planning out your hobby business, don't forget that local requirements and taxes will increase your costs of doing business, in both time and money. Lots of small business owners are surprised to find out that state and local tax regulations for small businesses can be more of a bear than IRS rules. For example, if you sell tangible products, you might be subject to state sales taxes. Plus, many cities impose taxes or fees on small businesses and require them to go through a registration process, and counties often have similar requirements for businesses in rural areas. Generally speaking, these rules apply to any money-making activity within the locality—even if the hobby business doesn't intend to claim any federal or state tax deductions.

Entrepreneur's Insight

John Tilles, cofounder of Portland Kayak Company, a river rafting outfit in Portland, Oregon (www.portlandkayak.com)

The real can of worms for us was in dealing with taxes. As a new and under-capitalized business, a professional accountant was out of the question. This left me to figure it out as I went, which was pretty straightforward in the early days, but, as the years went on and things became more complicated, I finally had to use a professional C.P.A.

In practice, many tiny hobby businesses—so tiny that the word "business" even seems excessive—might be able to get away unnoticed, assuming they don't deduct business losses on their tax returns. Even so, you should be aware that, depending on your local rules, you may be penalized if you're caught doing business without the permits or licenses required by your state or local government. Penalties may include fines and back taxes.

Income Taxes for Sole Proprietors

As mentioned throughout this book, a sole proprietorship is one and the same as its owner (the sole proprietor) for most legal and tax purposes. It follows that the sole proprietor must report and pay federal and state income taxes on all business profits, including any profits the sole proprietor leaves in the business for expansion. In other words, the business itself does not file tax returns or pay income taxes. (Note that the Tax Cuts and Jobs Act of 2017 created a tax deduction for owners of pass-through entities. See the sidebar "Tax Deduction for Pass-Through Entities," below.)

Federal Income Taxes

You're probably already familiar with the process of filing IRS Form 1040, based on income you earned at a job.

Good—this means much of the process of filing federal income taxes as a sole proprietor will already be familiar to you. That's because income from your business will be treated as personal income, which you report on Form 1040 much as you report wages or returns on investments. But you'll have to take two additional steps: You'll use a separate sheet (called Schedule C) to report your business profit, and you'll also pay self-employment taxes based on your income, reported on Schedule SE.

Income Tax

You report business profits or losses on Schedule C, *Profit or Loss From Business* (*Sole Proprietorship*), which is submitted once a year with your 1040 return, usually by April 15. A sole proprietor who owns more than one business must file a separate Schedule C for each business. You're not required to file Schedule C if your sole proprietorship doesn't make at least $400 profit in the business year, though it's a good idea to file one anyway. If your business loses money in any year, filing Schedule C allows the loss to be deducted from any other income you make for that year, reducing your total taxable income. Or, you can carry over the loss into a future profitable year to offset those profits and thereby reduce your taxes. Another reason to report losses or profits under $400 on Schedule C is that doing so triggers the beginning of the time window during which the IRS can audit you. Otherwise, the IRS can audit you anytime, virtually forever.

Simplified Tax Schedule for Super-Small Sole Proprietorships

Extra-small sole proprietorships might be able to use a simplified schedule to report their income, Schedule C-EZ *Net Profit from Business*. To use this simplified form, which works just like Schedule C, you must have:

- less than $5,000 in business expenses
- no inventory during the year
- no employees during the year
- used the cash method of accounting (see Chapter 12 for an explanation of the difference between the cash and accrual methods of accounting)
- owned and operated only one sole proprietorship during the year
- not deducted expenses for business use of your home, and
- not reported a net business loss.

If you depreciate assets or have unallowed passive activity losses from previous years, you might not be able to use this schedule. See the IRS instructions for details on who may use Schedule C-EZ.

Though Schedule C-EZ is easier to fill out than Schedule C, you won't save enough time or trouble to warrant trying to squeeze a too-large business into it. Don't, for example, neglect to claim more than $5,000 in business expenses or to claim depreciation expenses just so you qualify to use the schedule. The marginal convenience of the simplified schedule just isn't worth it.

Tax Deduction for Pass-Through Entities

Under the Tax Cuts and Jobs Act, effective in the 2018 tax year, taxpayers with a qualified trade or business (more on this below), including sole proprietorships, partnerships, LLCs, and S corporations, will be able to deduct 20% of their qualified business income. This deduction was added to achieve parity between pass-through entities and corporations, which were given major tax breaks (corporate taxes are discussed below). This provision is set to expire on December 31, 2025.

So, for example, if your solo freelance business generates $100,000 in profit, you'll be able to deduct $20,000 before income tax is calculated, based on your personal tax bracket.

What is a "qualified pass-through business," you ask? It includes any trade or business *other than* a "specified service trade or business" which includes a wide range of service businesses from health, law, and accounting to performing arts, consulting, and financial services. The good news for these types of businesses is that they also get the 20% deduction as long as their business income is not higher than $157,500 for single filers, or $315,000 for those who file a joint return. The deduction phases out for owners of specified service businesses with incomes above this limit.

The Tax Cuts and Jobs Act made the biggest changes in U.S. tax law in decades, so it's an especially smart idea to talk with a knowledgeable accountant about your situation.

There's an important procedural difference between reporting and paying taxes on income from a job and income from a sole proprietorship: Regular employees are subject to tax withholding by their employers, but sole proprietors usually have to estimate their taxes for the year and pay them in quarterly installments. The IRS is a stickler when it comes to making these quarterly payments and won't hesitate to fine you for doing it incorrectly or late, and especially for not doing it at all. Even if you pay your taxes in full by April 15 (or whenever your business year ends), failure to make quarterly payments means you'll be charged a penalty, typically about 9%. (See "Estimating and Paying Your Taxes Quarterly," below.)

Self-Employment Taxes

Sole proprietors must also make contributions to the Social Security and Medicare systems, called "self-employment taxes." Regular employees contribute to these two programs through deductions from their paychecks. Sole proprietors must make their contributions when paying their other income taxes. And they have to pay more than employees do—employees have to pay only half as much into these programs, because their contributions are matched by their employers. Sole proprietors must pay the entire amount themselves.

Reporting and Paying Are Not the Same

As you read about the often-complex rules of taxes, keep in mind that having to report income is not the same as owing tax on that income. Sometimes, a tax agency like the IRS or your state tax office requires you to submit a tax return even if you don't owe any taxes. Generally, a "filing" or "reporting" requirement means simply that you need to provide income and expense information, which may not add up to an actual tax obligation.

The self-employment tax rate is 15.3%, of which 12.4% goes towards Social Security and 2.9% goes towards Medicare. While the Medicare portion is calculated based upon a sole proprietor's total profits, the Social Security portion is capped at a certain amount that changes each year ($160,200 for 2023, and projected by the Social Security Administration to be $170,400 in 2024).

In other words, profits of $160,200 and less will be taxed at 15.3% (Social Security and Medicare combined), and profits above that will be taxed at 2.9% (Medicare only). In comparison, regular employees pay only a 7.65% tax on wages of $160,200 or less, and a 1.45% tax on wages above that. Note also that there is a Medicare surtax of 0.9% on income above $200,000 for individuals and $250,000 for couples filing jointly.

Fortunately, this dark tax cloud has a small silver lining: Half of the total self-employment tax you'll pay can be deducted from your taxable income at year's end. And if your sole proprietorship makes less than $400 profit in the business year, you don't have to pay self-employment taxes.

Self-employment taxes are reported on Schedule SE, which, like Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, you'll submit yearly with your 1040 income tax return. Once you determine the amount of self-employment taxes you owe on Schedule SE, you enter the result on your 1040 form in the "Other Taxes" section and add it to your personal income tax obligation. Remember, however, that most sole proprietors must estimate their total taxes for the year and pay them in quarterly installments. (See "Estimating and Paying Your Taxes Quarterly," below, for more information.)

State Income Taxes

You must report and pay state income taxes in much the same way as federal income tax. Any profit generated by a sole proprietorship is generally treated as personal income of the sole proprietor and reported on an individual state tax

return. In most states the sole proprietor will need to attach a separate schedule, similar to the federal Schedule C, to report business income. Unlike the federal rule, some states require this schedule to be filed even if a business loses money or makes less than $400 profit. In these states, you won't owe any taxes unless you've made a profit, but you must file the form in any case.

Like federal taxes, many states require businesses to estimate and pay their income taxes in quarterly installments.

Income Taxes for Partnerships

Although a partnership itself does not pay taxes (its owners do), it does need to submit an annual informational return to the IRS—and usually the state—to report its income. As is true for sole proprietorships, only the partners (business owners) pay taxes, not the business itself, and the partners have to pay taxes on all business profits, whether or not they take any money out of the business (though the 2017 Tax Cuts and Jobs Act provides a 20% deduction on qualified business income for pass-through entities; see the sidebar "Tax Deduction for Pass-Through Entities," above). This section explains what partnerships need to do to comply with the IRS and state rules.

Federal Income Taxes

Partnerships are called "pass-through tax entities," which means that profits pass right through the business to the owners, who report them on their individual income tax returns. The partnership itself is not taxed, but it must report its income and losses each year. (Although few do, a partnership can also elect to be taxed as a corporation, by submitting Form 8832, *Entity Classification Election, a*nd electing corporate tax status. You can find this form at IRS.gov.) Besides income taxes, partners must also file and pay self-employment taxes.

Income Tax

Even though the partnership itself does not pay taxes on profits, it must report profits and losses on an informational return, Form 1065, *U.S. Return of Partnership Income.* No tax is due with this return, which is generally due by April 15.

Along with Form 1065, the partnership must also submit a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, for each partner, reporting each partner's share of profits or losses. The IRS uses the K-1 schedule to inform the IRS of the partners' chosen profit division. Often, partners own equal shares of the business, which normally means they will choose to share profits and pay taxes equally—such as four

partners each getting 25% of a business's profits and paying 25% of its taxes. But if they choose, partners can divide profits and losses unequally. (See Chapter 1 for more on partnerships.) A copy of the completed K-1 must also be given to each partner on or before the date that the partnership return is due to the IRS.

As mentioned, profits earned by a partnership are taxed as personal income of the individual partners. Each partner reports an allocated share of business income or losses on an individual federal income tax return (Form 1040) using Schedule E, *Supplemental Income and Loss.* Schedule E repeats the income information reported on Schedule K-1 (which each partner should have received from the partnership). Because the partnership already filed Schedule K-1 with the IRS, partners do not need to submit this schedule with their individual tax returns.

Partners who earn income from a profitable partnership often must estimate their taxes and pay the total in quarterly installments.



SEE AN EXPERT

When partners don't share and share alike. Remember that each partner is taxed on their allocated share of the partnership profits, not on the amount actually distributed. However, it is possible in some circumstances for partners to legally divide items on a less-than-even basis. For instance, they could agree that one partner may deduct, on their personal tax return, all the interest paid on a partnership property mortgage. But a partner's share of partnership losses that can be deducted is limited to the partner's basis (investment) in the partnership. You should see a tax attorney if you want to get into this kind of tax planning.

Self-Employment Taxes

Partners and other self-employed individuals who earn more than $400 profit during the business year must contribute to Social Security and Medicare through federal self-employment taxes.

The self-employment tax rate is 15.3%, of which 12.4% goes towards Social Security and 2.9% goes towards Medicare. While the Medicare portion is calculated based upon the partner's total share of profits, the Social Security portion is capped at a certain amount that changes each year ($160,200 for 2023, and projected by the Social Security Administration to be $170,400 in 2024).

Put another way, profits of $160,200 and less will be taxed at 15.3% (Social Security and Medicare combined), and profits above that will be taxed at 2.9% (Medicare only). Note also that there is a Medicare surtax of 0.9% on income above $200,000 for individuals and $250,000 for couples filing jointly.

On a brighter note, partners can deduct half of the total self-employment tax from their taxable income at year's end. And when partners make less than $400 in profit, they do not need to file or pay any self-employment taxes.

Self-employment taxes are reported on Schedule SE, which, like Schedule E, *Supplemental Income and Loss*, is submitted yearly with a partner's 1040 return. Once you determine your self-employment tax with Schedule SE, enter the result on your 1040 form in the "Other Taxes" section, which you must add to your personal income tax obligation. But don't forget about estimating and paying taxes quarterly—most partners of profitable businesses must do so, or face the IRS's penalties. (See "Estimating and Paying Your Taxes Quarterly," below, for more on quarterly taxes.) A husband and wife who operate a business as partners must each report their share of the business profits as net earnings on separate Schedule SEs, even if they file a joint 1040 return.

State Income Taxes

Like the federal government, most states require partnerships to file informational returns reporting business income and losses. Fortunately, many of these state forms are almost identical to the federal Form 1065. Partnerships may also be required to file a schedule analogous to the federal Schedule K-1 for each partner, indicating the partner's share of the business profit or loss. The partnership must give each partner a copy. Typically, the state schedules are similar to the federal version but account for differences between state and federal tax laws. No tax is due with the partnership return or schedules.

Any partnership profit is taxed as personal income of the partners, who report their shares on their individual state income tax returns. Partnership income is usually recorded on a schedule similar to the federal Schedule E and included with the state tax form. Keep in mind that some states require partners to file this schedule even if the partnership loses money and no taxes are due.

Finally, like federal taxes, state income taxes must often be paid in quarterly installments.

Income Taxes for LLCs

The limited liability company or LLC (explained in greater detail in Chapter 1) combines several features of the traditional partnership and corporation with the reporting simplicity of a partnership or sole proprietorship. LLC owners enjoy the protection from personal liability that a corporation offers, while avoiding

the complicated and often expensive corporate tax system. LLC profits are taxed to the owners as individuals (like a sole proprietor or owners of a partnership). (The 2017 Tax Cuts and Jobs Act provides a 20% deduction on qualified business income for pass-through entities; see the sidebar, "Tax Deduction for Pass-Through Entities," earlier in this chapter.) Although members (owners) can choose to have the LLC taxed like a corporation, most owners choose to be taxed like a pass-through entity (see Chapter 1 for reasons why some LLCs may want to be taxed like corporations). The information in this section is for LLCs that will stick with pass-through tax status.

Federal Income Taxes

Like owners of partnerships, most LLC owners will report business profits on their individual federal income tax returns. Although this means the LLC itself is not taxed, it must still report its income and losses to the IRS each year if it has two or more members. In addition to regular income taxes, members may be obligated to pay self-employment taxes, which are also based on business income.

Income Tax

LLCs with only one member are treated as sole proprietorships for tax purposes, so that business profits and losses are reported on Schedule C, to be submitted with the member's regular individual income tax return. If the LLC has two or more members, it must file an annual informational return with the IRS, similar to the requirement faced by partnerships. Because the IRS hasn't yet come up with tax forms specifically for LLCs, LLC profits and losses are reported on Form 1065, *U.S. Return of Partnership Income.* No tax is paid with this return, which is generally due by April 15.

Along with Form 1065, an LLC must also submit a Schedule K-1 to the IRS for each member (again, the same schedule used by partnerships), reporting each member's share of profits or losses. The K-1 schedule informs the IRS of the members' chosen profit division. Owners must give a copy of the completed K-1 to each member on or before the date that the LLC return is due to the IRS.

Often, members own equal shares of the business, which normally means they will choose to share profits and pay taxes equally—such as four members each getting 25% of a business's profits and paying 25% of its taxes. But if they choose, LLC members can divide profits and losses unequally. (See Chapter 1 for more on LLCs and profit allocations.)

Profits earned by an LLC are taxed as personal income of the individual members. Members use the information from Schedule K-1 to report business income or

losses on their individual federal income tax returns (Form 1040) using Schedule E, *Supplemental Income and Loss*. Because the LLC will already have filed Schedule K-1s with the IRS, members do not need to submit this form with their returns.

Like sole proprietors and partners, LLC members will have to estimate their taxes for the year and pay them in quarterly installments.

Self-Employment Taxes

LLC members who earn more than $400 profit during the business year must contribute to Social Security and Medicare through federal self-employment taxes. The self-employment tax rate is 15.3%, of which 12.4% goes towards Social Security and 2.9% goes towards Medicare. While the Medicare portion is calculated based upon the member's total share of profits, the Social Security portion is capped at a certain amount that changes each year ($160,200 for 2023, and projected by the Social Security Administration to be $170,400 in 2024).

This translates into a 15.3% tax on profits up to $160,200 (Social Security and Medicare combined), and a 2.9% tax on profits above that amount (Medicare only). By comparison, regular employees pay only a 7.65% tax on wages of $160,200 or less, and a 1.45% tax on wages above that. Note also that there is a Medicare surtax of 0.9% on income above $200,000 for individuals and $250,000 for couples filing jointly.



CAUTION

It's not always clear whether an LLC member owes self-employment taxes. Generally speaking, an LLC member who is actively involved in the business must pay self-employment taxes, while an LLC member who is inactive and merely invests in the company may be exempt from the self-employment tax obligation. Knowing where to draw the line—when a member's participation moves from passive to active—involves a judgment call that can be difficult to make. If you're not sure whether this tax would apply to you, consult an accountant to get a definitive answer for your situation. (Chapter 17 gives information on finding professionals to advise you.)

Fortunately, if self-employment taxes are due, you can deduct half of the total self-employment taxes you pay from your taxable income at year-end. And an LLC member who earns less than $400 profit in the business year will be totally exempt from having to pay self-employment taxes.

Self-employment taxes are reported on Schedule SE, which, like Schedule E, *Supplemental Income and Loss*, you'll submit yearly with your LLC member's 1040 return. Once you determine the self-employment taxes you owe on Schedule SE, enter the result on your 1040 form in the "Other Taxes" section, which you'll add to your individual income tax obligation. If the LLC member is required to pay advance quarterly tax installments, however, any self-employment taxes will be included in those payments.

State Taxes

Though the federal government treats LLCs with pass-through tax status almost exactly like partnerships, the tax treatment LLCs receive in their states of formation varies. Most states follow the IRS's lead and treat LLCs as pass-through entities unless the members have elected corporate tax treatment for the LLC. Some states, however, also impose special taxes on LLCs themselves, despite treating them as pass-through tax entities in most other respects.

Most states collect income tax from LLC members on their share of business profits, following the IRS classification scheme for LLCs, which treats LLCs as either partnerships or sole proprietorships. An LLC with a single owner is usually treated as a sole proprietorship, and business profits will be taxed on the sole member's individual state income tax return. LLCs with two or more owners are typically treated as partnerships and must file the same tax returns as owners of partnerships in that state.

Unlike the IRS, which imposes no taxes on LLCs themselves, several states levy taxes on LLCs in addition to taxing LLC members on their share of LLC income. These taxes are alternately called "franchise taxes," "annual fees," "surcharge taxes," or other similar names. Depending on the state, these additional costs can range from $10 to thousands of dollars, so be sure to understand your state's rules well in advance of tax time.

Like federal taxes, state income taxes for members must often be paid in quarterly installments.

Estimating and Paying Your Taxes Quarterly

Anyone who earns income from a business must pay income taxes in quarterly installments over the course of the business year. However, some businesspeople who expect to owe little or no income tax are exempt from these estimated payment requirements. At year end, if you've paid more than what you owe, you'll get a refund. On the other hand, if you didn't pay enough in your quarterly installments, you will owe more.

This system isn't all that different from the way taxes on employment wages are handled. From each paycheck, the federal (and often state) government requires an employer to withhold income taxes from each employee's wages based on the employee's expected annual salary or hourly pay. At year end, the employee

calculates and reports a personal tax obligation based on how much money was actually earned during the year. Depending on the dollar amount of the tax obligation, the employee will either owe more money (if the employer didn't withhold enough) or be due a refund (if the employer withheld too much).

Unfortunately, it's much easier for an employer to figure out an employee's estimated tax burden based on individual yearly salary or hourly wage than it is for a small business owner to estimate taxes based on future income from a new and unproven business. Projecting future income in order to estimate your tax obligation can be a dicey task, especially for brand-new business owners whose income hasn't yet evened out into any predictable rhythm. To make matters worse, you'll be socked with a penalty if your estimates are off and you don't pay enough each quarter.

But here's the good news: You don't need to start making estimated tax payments until you earn enough income to subject you to a threshold quarterly payment requirement. This should give you enough time to get a pretty good feel for how much and how quickly money—and, by extension, taxable profits—is coming into your business. And even if you do underestimate your taxes and face a penalty of a few hundred dollars, you can at least take heart that you owe extra only because your business has become profitable sooner than you anticipated.

In addition to the IRS, many state tax agencies require profitable businesses to make estimated tax payments. For the most part, these states' rules are similar to the federal one, but they use slightly different formulas. The rest of this section will address just the federal requirement; check with your state tax agency to find out its formula for estimating taxes.

Who Must Pay Estimated Taxes?

Business owners have to pay federal estimated taxes if they expect to owe at least $1,000 in federal taxes for any particular year (including income taxes and self-employment taxes). This means you'll have to make estimated payments if your adjusted gross income (taxable net profits minus tax exemptions, deductions, and credits) will be between $3,000 and $6,000, depending on your tax bracket. The point here is, if your business is at all profitable, count on estimating and paying your taxes quarterly. On the other hand, if you're operating at a net business loss or making next to nothing, you might not have to make estimated payments.

EXAMPLE: On December 31, as part of a New Year's resolution, Jason quits his job as a computer salesman and opens a river rafting outfit called the Rapids Transit Company. For the first few months of the next year, every dollar he takes in pays for equipment, insurance, and marketing. At the rate he's going, he doesn't know if he'll make a profit at all that year, so he doesn't worry about estimated taxes. However, starting in June with the heavy tourist season, he starts clearing about $1,300 per month, after all deductions. He thinks he might have at least four more months like that before winter slows business down. If so, his annual profit will be about $6,500 ($1,300 × five months). Depending on his tax status, he'll probably owe between $1,000 and $2,000 in taxes at the end of the year. He realizes he'd better start making estimated quarterly payments to be safe, or risk a penalty.

Now for the nitty-gritty. The IRS has a relatively straightforward formula (okay, that might be stretching things just a bit) for determining whether you need to estimate and pay your taxes in installments. You'll have to pay estimated taxes if you expect:

- to owe at least $1,000 in federal taxes (including income taxes and self-employment taxes) for the current year, after subtracting any withheld taxes, and
- your withheld taxes and credits will be less than the smaller of:
  - 100% of your total tax owed for the previous year, or
  - 90% of your total tax obligation for the current year.

Your Day Job Might Help You Avoid Estimated Taxes

If, in addition to the business you own, you work at a job on which taxes are withheld from your income, you might not have to pay estimated taxes if your income from your business is not a significant part of your total income. This is because the taxes withheld from your job might cover you for any estimated taxes owed on your business income. In other words, the IRS wants to make sure that a certain portion of the total taxes you'll owe are paid in installments over the year, but it doesn't care whether those taxes are withheld from your paycheck or paid as estimated taxes. It's possible that the taxes withheld from your paycheck will be enough to meet your entire tax obligation. On the other hand, if your business is bringing in significant income, chances are that your wage withholding won't cover your tax bill.

This formula sounds complicated, but it's not. First, it requires you to make estimated payments only if you expect to owe at least $1,000 to the IRS at year's end, above and beyond any taxes withheld from wages. This translates to about $3,000 to $6,000 in adjusted gross income from your business, depending on your tax bracket. So if your business is barely breaking even, you probably won't have to make estimated payments.

Second, if you do expect to make at least that amount from your business, you

might not have to pay estimated taxes on your business income if enough taxes are withheld from a paycheck (assuming you receive one). If the taxes that your employer withheld from your paycheck in the current year will add up to more than 90% of what you'll owe in taxes, you won't have to make estimated payments. Or, if that's not true, there's one more way you can escape making estimated tax payments: If the taxes withheld in the current year will add up to at least what your entire tax bill was for the previous year, you're free of the estimated tax requirement.

EXAMPLE: Nels works as a manager of an auto parts store, which pays him a salary and deducts federal and state taxes from each paycheck. He starts a sole proprietorship called Falcon's Auto Tow, operating his new business while remaining on the job at the store. In the first few months of his auto-towing business, Nels operates at a loss. Because his only taxable income during those months is from his paychecks, on which taxes are withheld, he doesn't have to worry about estimated payments. In the fifth month, his towing business starts to turn a profit, at which point Nels starts to pay attention to whether he must pay estimated taxes. If he thinks his wage withholding will account for at least 90% of his total tax bill at the end of the year, he doesn't need to file and pay estimated taxes. In other words, if he thinks that taxes on his small business income will account for less than 10% of his total tax bill, he'll just file his taxes at year end like most people whose entire income is subject to wage withholding.

Defining Your Business Year

Except for C corporations, a business must use the calendar year as its business year unless it gets permission from the IRS to choose a different starting and ending point. A bit of tax jargon is important here. Any one-year period other than the calendar year (ending on December 31) that a business uses for tax purposes is called a "fiscal year," a "tax year," or an "accounting period." The IRS allows sole proprietorships, partnerships, LLCs, and S corporations to use a fiscal year only if it has a valid business reason, such as experiencing significant seasonal fluctuations in business. Fiscal years must begin on the first day of a month and end on the last day of the previous month one year later. An unincorporated business that wants to use a fiscal year must submit Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* to the IRS and have it approved.

Most businesspeople, of course, anticipate becoming profitable eventually—preferably sooner than later—so at some point you'll need to start paying estimated taxes. In the real world, what usually happens is that once you become profitable and owe income taxes for the first time, your accountant will calculate the next year's estimated tax payments based upon what you owed the previous year. The accountant will likely even

prepare the vouchers for you, so all you have to do is send in the payment with the voucher stub by the applicable deadline.

When to Make Estimated Tax Payments

Each quarterly payment must be filed a half-month after the end of the quarter. For federal estimated taxes, the quarterly due dates are as follows:

Income made during:	Tax installment due:
Jan. 1 through Mar. 31	April 15
Apr. 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 of the next year

If your business uses a fiscal rather than a calendar year, your payments will be due on the 15th day of the 4th, 6th, and 9th months of your fiscal year and the 1st month of the following fiscal year.



CAUTION

Don't overlook your self-employment taxes. Self-employment taxes, like income taxes, are subject to the estimated tax payment requirement. Be sure to include them when figuring your estimated tax burden for the year.

For more information on federal estimated tax payments, refer to IRS Publication 505, *Tax Withholding and Estimated Tax*, available online at www.irs.gov.

City and County Taxes

Unlike the federal or state governments, many cities and counties impose taxes directly on your business, even if your business is a pass-through entity such as a sole proprietorship, partnership, or limited liability company. Of course, you as the owner are personally liable for these financial obligations, but the difference is that your business itself—not merely the profits that flow through to you and any other owners—incurs taxes levied by local governments. Often, these taxes can be more of a burden than federal or state ones, because many of them are based on your business income before you deduct business costs and expenses. Some areas, for instance, impose a gross receipts tax, which calculates the tax based simply on how much total income your business brings in, without regard for your expenses.

Local taxes vary a lot from one area to the next, but your business can always expect to face some sort of "business taxes" from your city or county, which can include property taxes.

Business Taxes

The vague term "business taxes" simply refers to the tax your local government imposes on all businesses within the city or county limits. Businesses in rural areas will probably deal only with their county tax authority. Whether the tax is imposed by a city or a county tax authority, the information about business taxes provided in this section generally applies.

Unlike the IRS and most state tax agencies, which simply collect taxes after they're incurred, most local tax collectors require you to go through a tax registration process before you start your business. (An overview on how the registration process works is provided in Chapter 7, Step 4.) Once you've registered, you'll get what's commonly called a "tax registration certificate" (or sometimes, inaccurately, a "business license"). Registration gives notice to your local tax authorities that your business exists and allows them to tax it, based on the method your locality has adopted for your type of business.

In many cities and counties, you actually start paying your local taxes when you purchase your business license or registration certificate. Often, a locality will base its registration fee on your expected local tax for the year. In some localities, your registration fee is like a prepaid tax that can be applied toward your total year-end tax. In other places, the registration cost is purely an administrative fee and cannot be applied to your tax bill. And in still other areas, part of the registration cost is a prepaid tax that can be credited toward your tax bill, and part is an administrative fee.

The taxing schemes used in various cities and counties are usually based on certain attributes of your business. Most localities divide businesses into different categories or types, such as retail sales, wholesale sales, hotels/apartments, and service businesses. Each category uses a certain criterion to calculate taxes, usually called a tax base. A common tax base, for example, is "gross receipts" (total income, before expenses). Each category has a certain tax rate for each tax base.

For example, in Oakland, California, retail sales businesses (Code A) with gross sales of $1 million or less must pay $60 plus .09% of their gross receipts in excess of $66,666.

Recreation and entertainment businesses (Code G) in Oakland also have gross receipts as their tax base, but must pay $60 plus 4.2% of their gross receipts in excess of $14,285 (again for businesses with gross sales of $1 million or less). Other criteria used as tax bases include total payroll, number of employees, and number of company vehicles. Other tax bases exist as well.

For instance, in Sacramento, California, cannabis businesses pay 4% of their gross receipts. Professionals such as accountants, attorneys, and podiatrists in Sacramento pay taxes based on the number of years they have been licensed in the state. The moral of the story here is that local tax systems have just about as many ways of taxing your business as there are types of businesses.

Because rules vary widely from city to city and county to county, you'll need to check with your local tax agency to find out how it will tax your business.

When searching for the appropriate tax agency, look online or in the government section of your telephone book under City Government (or County Government if you live in an unincorporated area) for names such as "Tax Collector," "Business Licenses and Permits," or "Business Tax Division." And, because local taxation of businesses is usually closely tied to start-up registration requirements, most businesses will automatically receive tax-filing information either when they register or soon after by mail. (For more information on start-up registration requirements, see Chapter 7.)

Property Taxes

Many localities impose taxes on certain kinds of business property, such as real estate, business equipment, furniture, and vehicles. Property tax reporting procedures vary considerably from area to area, but a common requirement is for businesses to provide their local tax authority with an itemized list of business property subject to tax. Check in your area to determine whether any property taxes apply to your business and how to go about paying them.

Sales Taxes

In many states, retail sales are subject to state, county, and local district sales taxes. They are often just referred to as state sales taxes, because they're often filed and paid to one state sales tax agency with just one return. In states that use this system, it's up to the state sales tax agency to distribute the collected taxes to the counties and districts across the state.



CAUTION

Sales tax rules are closely related to seller's permit requirements. Recall from Chapter 7 that most businesses that engage in retail sales must apply for a seller's permit. This can be true even if the business ultimately makes no taxable sales—for instance, if all sales fall into a tax-exempt category, like groceries. (See Chapter 7 for help in figuring out whether your business needs a seller's permit.)

Taxable Versus Nontaxable Sales

In most states that impose sales taxes, the general rule for whether a transaction is taxable is that the sale must:

- involve the sale of a tangible item, and
- be made to the final user of the item.

Tangible items are things you can touch, such as books, toys, or furniture. Nontangible items might include services, downloadable books, software, or intellectual property such as patents or copyrights.

A final user is a consumer—either an individual or a business—rather than a reseller (a wholesaler or distributor). Sales that are made directly to end users (consumers), rather than resellers, are retail sales (taxable). Sales to resellers are wholesale sales (nontaxable). This means that if you operate as a wholesaler and sell tangible goods to resellers who will in turn sell them to consumers, your sales are likely exempt from sales tax.

Keep in mind, however, that this rule is by no means uniform from state to state. For instance, some states consider sales of software to be taxable sales of tangible items, but others do not. A common source of confusion is the fact that states often have unique (to put it delicately) definitions of the terms "tangible item," "final user," or whatever other terms apply within the state. For example, in the late 1990s, more than a few graphic artists in California were surprised to learn that the state did not consider their transactions to be services (which are not taxable in California), but instead to be taxable sales of tangible items, merely because the artists' work was given to the client on a physical piece of paper. The sales tax regulations were amended in 2002, resulting in more fair treatment of graphic artists' work. The point here is not to rely on common definitions, but to find out specifically how your state tax agency interprets sales tax terminology.

Sales Tax Exemptions

Part of the reason that the rules on sales taxes are so convoluted is that the "rules" are clouded by swarms of exceptions and exemptions. Here are several examples of common exemptions from sales tax:

- most groceries (but not restaurant or take-out food)
- sales to out-of-state customers
- sales to the U.S. government, and
- some sales related to the entertainment industry.

Rules about which sales are exempt from sales tax vary from state to state, so be sure to check with your state sales tax agency. For general information, see The Sales Tax Clearinghouse, http://thestc.com.

Besides the fact that many states use broad definitions in deciding what is taxable, a few states diverge from the general rule described above. Unlike the majority of states, Hawaii, New Mexico, South Dakota, and West Virginia impose taxes on all or almost all services. Still other states charge taxes on certain services, and others tax services when they're performed along with a taxable sale of a tangible item, such as charges for delivering a taxable item. Again, the state rules regarding these sales tax situations are complex and fraught with exceptions, so it's crucial that you check with your state agency to learn the details that apply to your business.



CAUTION

You might need a permit to sell tangible goods. As we mentioned earlier, businesses that sell tangible goods must typically obtain a seller's permit from the state before sales begin, even if the sales aren't taxable (such as wholesale sales, discussed below). Selling tangible goods without a seller's permit is a misdemeanor crime in some states, but usually the state sales tax agency will give you the opportunity to comply by getting a permit before it files a criminal charge. But keep in mind that if you made any sales that were taxable before you got your seller's permit, you may be required not only to get a permit, but to pay all back taxes that are due.

Sales to Final Users Versus Sales to Resellers

As mentioned above, states generally tax only sales to the final user. The idea behind this rule is to make sure that items are taxed only once. For instance, rather than taxing the sale of a lamp each time it is sold—from its manufacturer to the wholesaler to the final customer—the state will impose tax only when it is sold to the final consumer.

How can you be sure that a customer is a final user? Customers who intend to resell your product should present you with a "resale certificate," which states that the product is being purchased for resale. Depending on your state's law, the certificate must usually contain certain information, including:

- the purchaser's name and address
- the number of the purchaser's seller's permit
- a description of the property to be purchased
- a statement that the property is being used for resale, in terms such as "will be resold" or "for resale" (language such as "nontaxable" or "exempt" is not enough)
- the date of the sale, and
- the signature of the purchaser or an authorized agent.

If you are not presented with such a certificate, you should assume the customer is the final user and treat the sale as taxable. If you sell to the same customer repeatedly, you'll usually need to collect only one resale certificate, which you should keep on file at your office. From then on, whenever you sell items to that company, you shouldn't have to collect another resale certificate.

Using Resale Certificates

Just as your customers can escape paying you sales taxes by presenting a resale certificate, you can use one to purchase goods and supplies free of sales tax as long as the goods and supplies are for legitimate resale. This applies whether you'll resell purchased goods as is, or whether you'll incorporate purchased supplies into your products. If you buy regularly from the same supplier, you should have to present your resale certificate only once.

This exception doesn't apply to goods and supplies that you don't plan to resell or use in manufacturing products. You must pay sales taxes on all items that you'll use in your business and not pass on to a customer. In other words, when you are actually the final user, you have to pay sales tax like anyone else. This includes sales tax on goods and supplies you use to perform services or operate your business. For example, a hairdresser must pay sales tax on the shampoo used to wash hair.

Similarly, if you purchase a computer to keep track of your sales, you should pay the sales tax on that purchase. When purchasing a combination of goods, only some of which you intend to resell, you should clearly indicate which items are for resale and pay sales taxes on the rest.

Online Sales in the Internet Age

In the pre-internet economy, sales tax rules were heavily affected by the physical location of a business—specifically, whether it had a connection (or "nexus") in the form of a physical presence in the state where it conducted sales. Businesses were required to collect sales taxes only on sales conducted within states where the business had a physical presence—you needed either a brick-and-mortar location in the state or an employee (such as a salesperson) based there. But as online sales exploded, states understandably wanted to tax more transactions, and legislators began to define nexus more broadly to include purely economic contacts.

The Supreme Court changed the rules in a landmark 2018 case, *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018) (commonly known as *Wayfair*). The Court

ruled that states have the authority to impose sales tax on sellers even when they have no physical location in the state where the buyer is located. Put another way, pre-*Wayfair*, simply shipping a product or a catalog to a customer in a certain state wasn't enough to establish a nexus in that state. With the *Wayfair* case, nexus was decoupled from physical location and may be present when remote sellers meet a minimum amount or number of sales in a state. The result is that many online sellers and mail-order businesses will now be considered to have a nexus within a state, even if they have no office, building, employee, warehouse, affiliate, or other physical presence there.

With this more inclusive definition of nexus, many businesses will be subject to the sales tax laws of other states where they conduct sales. When that's the case, they must comply with any requirements for getting a seller's permit, as well as for collecting, reporting, and paying the tax to the state.

The judges who broadened the reach of online sales tax acknowledged the potential and actual complications for sellers who must comply with numerous state tax agencies and requirements. The judges noted the importance of exempting some small sellers for whom compliance would be too burdensome. The South Dakota law at the heart of *Wayfair*, which is now in effect, is considered a model for laws that will pass legal muster; it exempts sellers with annual sales of less than $100,000 or fewer than 200 transactions.

By the time this book goes to print, many similar state laws will be newly effective, and many more are in legislative pipelines. The best way to make sure you understand and comply with the laws that apply to your sales and business operations is to talk with an accountant or bookkeeper who is familiar with your state's sales tax approach for online sales. Bear in mind that many legislative changes are still happening (including proposed federal legislation), and more court decisions are sure to follow. So stay tuned for more developments.



RESOURCE

The Sales Tax Institute (www.salestaxinstitute.com) offers in-depth information, updates, and state-by-state guides on how to stay in compliance with state sales tax laws after *Wayfair*. Its "Economic Nexus State Guide" is regularly updated with new state legislation as it is passed.

Use Taxes

A "use tax" is another tax that comes into play when purchasing something from an out-of-state seller. This tax can affect you

more as a purchaser than as a seller, as state laws typically put the burden of use taxes on purchasers, not sellers. In keeping with its name, a use tax is due when you use a tangible good on which you didn't pay sales tax. If the transaction would have been taxed if it had been made within the purchaser's home state, the purchaser is obligated to pay use tax on the transaction.

For instance, if you order office furniture from an out-of-state mail order catalog, you may not have paid sales taxes on those items, as many sellers (especially pre-*Wayfair*) did not collect sales tax from out-of-state purchasers. But this loophole has for many years (as in, way before *Wayfair*) been addressed by use tax laws, which oblige purchasers to pay essentially what the sales tax would have been if you had bought the equipment within the state.

Remember, under the new *Wayfair* rules, more sellers are authorized to collect and pay sales taxes on out-of-state sales. So in many cases, there's less of an incentive to make purchases from out of state. But *Wayfair* hasn't changed the basic rule of use taxes, which is that they are due if the transaction wasn't taxed but would have been taxable if conducted in the purchaser's home state.

Other transactions subject to use tax include purchases of items you originally intended to resell (and bought tax free because you used your resale certificate) but used for another purpose, making you the final consumer after all. Inventory that you store for future resale is not subject to use tax.

To pay use taxes, you typically fill out a use tax return, which is often the same as or related to the one that your business will use for paying sales taxes to the state. Essentially, you'll enter information on the form about the purchases you made that are subject to use tax, and follow the form's instructions for calculating your tax. There's not much more to it than sending it off to the state sales tax office, along with a check (assuming you owe money).

There's a high blow-off factor when it comes to use taxes. Use taxes have largely been ignored by individuals and businesses, and the inherent difficulty of enforcing this tax allows virtually everyone to get away with it. However, some states that have traditionally been lax in enforcing and collecting use taxes are now stepping up their efforts to collect them. Particularly in today's environment of thriving e-commerce and state budget deficits, sales taxes on out-of-state purchases have become a red-hot issue. Keep an eye out for developments in this area, and don't get caught with your use taxes down.

Who Actually Owes Sales Taxes?

Despite the fact that most consumers pay sales taxes on a daily basis, there's a lot of misunderstanding out there over who really owes sales taxes—purchasers or sellers. Here's the deal: In most states, consumers are technically responsible for paying sales taxes. In these states, the retailer is essentially merely a collector for the sales tax owed by the consumer. In some states, however, the actual responsibility for sales taxes falls on the retailer. This sort of tax is sometimes called a "privilege tax," because businesses are taxed for the privilege of conducting retail sales.

Keep in mind that these are often technical distinctions without a whole lot of practical effect. For example, if consumers are legally responsible for paying sales taxes in a certain state, that doesn't mean that businesses can escape paying state sales taxes. Usually, all it means is that the business must state the selling price and the sales tax separately on receipts and invoices. That way, consumers see that they are in fact being charged sales tax.

Keeping Track of Your Sales

When you obtain a seller's permit in most states, you obligate yourself to file a sales (and use) tax return. You'll need to keep careful records of both your sales and purchases. Most state sales tax agencies require that you keep:

- books or computer files recording your sales and purchases
- bills, receipts, invoices, contracts, or other documents (called "documents of original entry") that support your books, and
- schedules and working papers used in preparing your tax returns.

In addition, if you conduct business in more than one county, city, or other local tax district, you might need to keep separate records of sales made in each area.

Finally, your records should show all sales your business makes, even sales that aren't taxable.

Calculating, Filing, and Paying Sales Taxes

Sales taxes in many states are actually a combination of state, county, and city sales taxes. For example, an 8% sales tax can actually break down into a 5% state tax, a 2% county tax, and a 1% city tax. The sales taxes that apply to your business will often depend on where your taxable sales are being conducted. If you conduct

taxable sales in more than one tax district, you could end up paying several different rates. Conveniently, many states allow businesses to file just one state tax return that includes all taxes for all applicable districts. The return will usually ask you to identify where your sales were made so that the state can allocate the fair share of taxes to each tax district.

Businesses that have been issued a seller's permit will often receive their state sales tax return package automatically, along with an account number, due date, and filing instructions. Depending on your sales volume, you'll need to submit your sales tax return yearly, quarterly, or monthly. Contact your state agency for details.

Filling out the sales tax return is generally fairly straightforward and will vary only slightly in format depending on the form used by your state. Basically, you'll enter sales information for each tax district in your state where you conducted taxable sales and identify the tax rates that apply to each of these sales. The return will typically walk you through the calculations and will tell you whether and how much sales tax you owe. In most states, you can get telephone assistance if you're having trouble filling out your return. Consult your state sales tax agency for detailed instructions on filing your sales tax return.



CAUTION

Sellers may be required to file sales tax returns. If you applied for and received a seller's permit because you anticipated selling goods, you might need to submit your sales tax return even if you never made a sale. If you didn't make any taxable sales, you shouldn't owe any taxes, but you might still need to submit the form. If you don't, you risk losing your seller's permit, which could mean you couldn't legally make any sales at all. Check with your state agency for its requirements.

Chapter 9 Checklist: Paying Your Taxes

- ☐ Become familiar with the general scheme of taxes faced by small businesses.
- ☐ Remember that you might have to pay estimated taxes in quarterly installments. Other taxes might also have to be paid more often than once a year, such as your state sales taxes. Make a calendar of important tax dates so you don't miss them and incur penalties.
- ☐ Keep careful track of your expenses so that you may deduct them.
- ☐ Consult a tax professional at least once a year to help you organize your books and keep your taxes to a minimum.
- ☐ File and pay your annual taxes each year, and other taxes as they become due.

CHAPTER

10

Laws, Taxes, and Other Issues for Home Businesses

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Just a generation ago, a home-based business was something of an outlier, but those days are long gone. The Small Business Administration's latest figures (2021) reflect that home-based businesses make up roughly half of the 31.7 million small businesses in the United States. The home business boom was largely fueled by the internet in the 1990s, and is currently going through another surge due to the radical shifts in workplace dynamics due to COVID-19. As more workplaces embrace remote work as a way of minimizing infection risk, business owners are increasingly opting to downsize their office space or forgo them altogether. No question about it, home businesses—and the industries that have grown around them—are here to stay.

If you're considering basing your business from home, consider the following factors:

- **Convenience.** Eliminating a commute leaves you more time for personal and family life.
- **Cost savings.** Not having to pay rent for an external office helps the bottom line of any business—especially important in the start-up days.
- **Realities of remote team management.** Many workers appreciate the option to work from home these days to reduce their risk of contracting COVID. Others miss the opportunity to work with others. If you have staff, you should pay attention to their preferences.
- **Access to the internet.** Most urban areas now have reliable broadband access, but not all. If you're far from urban infrastructure, you might be hampered by less-than-solid access.

Besides taking these considerations into account, it's important to realize that a home business isn't immune to a number of the requirements that affect businesses in general. Similar to a business operated from a commercial office space, a business run from home must comply with zoning requirements in its area. And home businesses are subject to several special tax rules, and have unique insurance issues, which you should understand. All of this is discussed in this chapter.

Home Business Zoning Restrictions

As you must do with leased office spaces, you need to make sure that the business activities you plan to carry on in your home are within the letter of your local zoning laws. You might also have to apply for a special "home occupation permit" before you begin. (Zoning laws typically refer to home businesses as "home occupations.")

Is a Home-Based Business Right for You?

Not all businesses lend themselves to being run out of a residence. Make sure you've considered whether using your home as your office is a good idea. Ask yourself the following questions:

- Do you plan to have staff? If you do, where will they work?
- How will you deal with customers and suppliers? Will they be able to easily park and pick up or unload material if necessary?
- Will customers take you and your company seriously if you work out of your house?
- Will your business require a lot of space for performing services or storing supplies?
- Can you work productively in your home, considering potential distractions, such as kids, the couch, the refrigerator, and the TV?
- Are you subject to private land restrictions? If you live in a condo, co-op, planned subdivision, or rental property, you are likely subject to private land use restrictions in addition to your local laws. Condo regulations, for instance, often contain language restricting or sometimes even prohibiting business use of the premises. Your apartment lease might prohibit business on the property.

Businesses that require nothing but a small office and don't generate much traffic coming and going—such as graphic design, accounting, and web development—and those in which most of the dirty work is routinely done offsite—such as construction and plumbing—are particularly well suited for home businesses.

If your home is in an area that's zoned for residential use only (some loft-type or urban apartments might be zoned for mixed use), the types of businesses allowed in your neighborhood will probably be pretty limited. A few areas actually forbid home businesses altogether. But most cities and counties allow home businesses that have little likelihood of causing noise or pollution, creating traffic, or otherwise disturbing the neighbors. Writers, artists, attorneys, accountants, architects, insurance brokers, and piano teachers are examples of businesspeople commonly allowed to work from home. Typically, not allowed are retailers, automotive repair shops, cafés and bars, animal hospitals and breeders, or any type of adult-oriented businesses.

Check With the Planning Department

To find out how your city or county deals with home businesses, call the planning department or visit its website. Ask or look for any information available on home businesses. Some areas have websites or pamphlets with information explaining home business restrictions and how to obtain any necessary permits. In other places, all that's available might be a grainy photocopy of the municipal code, which you'll have to decipher yourself.

If your area has no approval or permit process for home businesses, it's generally up to you to comply with the local zoning codes. And those codes are subject to change; be sure to check with the local zoning offices for updates.

The most foolproof way to avoid trouble with zoning officials is to do your best to keep your business's impact on the neighborhood to a minimum. As long as you're not in flagrant violation of the zoning laws regarding home businesses and your neighbors are happy, you'll probably be fine.



TIP

Let your neighbors in on your business plans. Getting to know your neighbors can be a huge help in avoiding problems with zoning officials. For instance, if your business requires people to come and go from your house or packages to be delivered daily, your neighbors might jump to the nutty conclusion that you're a drug dealer and report you to the city. Even though you can show your drug of choice is vitamin C, the city might unearth technical zoning violations that never would have otherwise turned up. As preventive measures, communicating with your neighbors and dealing with their concerns about issues such as parking and noise will greatly reduce the likelihood that the zoning police will come knocking on your door.

Understand Common Restrictions

Assuming that your local zoning laws allow your type of home business, they are likely to impose some restrictions, such as allowing only residents of your home to be employees, restricting the number of customers that may come to your house, limiting the percentage of your home's floor space that can be used for business, or prohibiting signs outside of your house that advertise the business. In Milwaukee, Wisconsin, for example, home businesses cannot employ anyone other than residents of the home, and the business may not use more than 25% of the usable floor area of the home, including the basement. In Austin, Texas, it is illegal for any equipment or process that creates noise, vibration, glare, fumes, odors, or electrical interference to be "detectable to the normal senses" off the lot. And in Sacramento, California, home businesses may keep only one vehicle on premises, not larger than one ton.

In addition to these general limitations, cities often impose restrictions on specific types of home businesses. For instance, a city might forbid any type of home business from having a neon sign, or it might have a special rule for landscapers that prohibits landscaping supplies from being kept at the home office. Be sure to learn from zoning officials or the local city hall whether your type of business is subject to special rules.

Comply With Local Requirements

If you discover that your city does allow your type of home business in your area, you might have no further need to contact the zoning office. Many cities do not require special permits, as long as a home business complies with all of the rules and restrictions contained in its planning code (as discussed above). Some cities, however, require all home business owners to get a "home occupation permit." Obtaining such a permit is usually a simple matter of filling out a form provided by the planning department and paying whatever fee is required. If your business meets the restrictions your city imposes, your permit will be issued.

If you don't meet all of your city's rules for having a home occupation, or your area isn't zoned for your type of home business, you could be out of luck and simply not allowed to run your business from home. In some locales, however, a home business that meets most but not all of the city's restrictions may be allowed to operate, but only after obtaining a home occupation permit. In San Diego, for instance, no permit is required for home businesses that meet all of the city's criteria (no business signs, no nonresident employees on the premises, and so on). If the home business deviates from the criteria, the city may allow the business to proceed, but only with a permit. Acceptable deviations in San Diego include having one nonresident employee, having one client who visits your home office by appointment, and using more than one vehicle for business.

Keep in mind that the zoning agency is probably not the only land use regulatory agency in your area. Even though your activity might be okay with zoning officials, operating out of your home might not pass other departments' requirements. For example, if you're starting a catering business, chances are your county health department won't let you work out of your home kitchen. You might be allowed to convert your garage or another separate structure into a professional kitchen—but, of course, that is likely to be contingent on securing building permits and passing county health inspections, in addition to zoning compliance or permission. (See Chapter 7 for more on permits for your specific business.)

The Home Business Tax Deduction

If your office is located in your home, you might be able to claim a portion of your home expenses—such as rent or depreciation, property taxes, utilities, and insurance—as a special deduction when reporting federal taxes. The IRS's general rule is that if your business qualifies (discussed below), you can deduct a pro rata share of home business expenses. "Pro rata" simply means a share that's proportional to the percentage of home space that you use for your business. Alternatively, since tax year 2013, you can calculate your deduction using a simpler formula: the square footage of your home office multiplied by a rate specified by the IRS. We'll explain both of these methods of calculating your deduction below.

This section explains which businesses can qualify for the home business tax deduction, how the deduction is calculated, and other tax issues that apply. (For information on how businesses in general are taxed, see Chapter 9.)



TIP

Many expenses are automatically fully deductible. Many taxpayers mistakenly believe that they need to qualify for the home business deduction before they can claim any expenses associated with a home-based business. But, in fact, you can deduct business expenses necessary for your business whether they're incurred in your home or anywhere else, even if you don't qualify for the home business deduction. For instance, you can always deduct the portion of your home long-distance phone bill that you spend on business-related calls.

Other deductible business expenses include office supplies, furniture, and equipment that you use in your home office; and the cost of bringing a second telephone line into your home for business use. As used in this chapter, "home business expenses" will refer to expenses that can be claimed only with the home business deduction.

IRS Requirements

Before tackling the nitty-gritty requirements, let's look at a couple of basics. First, the IRS definition of "home" is pretty broad, generally including any type of dwelling in which you can cook and sleep. This includes houses, condos, apartment units, mobile homes, boats, and wherever else you reside. Both renters and owners are eligible for taking the home tax deduction.

Moving on to the meat of the criteria, the IRS has two requirements for any business owner who wants to deduct expenses for using part of a home as a business:

- You must regularly use part of your home exclusively for a trade or business.
- You must be able to show that you:
  - use your home as your principal place of business
  - meet patients, clients, or customers at home, or
  - use a separate structure on your property exclusively for business purposes.

Each of these criteria is examined a bit more closely below.

Exclusive and Regular Use for Business

The IRS will allow you to deduct home business expenses only for space in your home that is 100% dedicated to business use. For example, a graphic designer who sometimes sits at the kitchen table to do illustrations can't claim business deductions for using the kitchen—assuming the kitchen is also sometimes used for nonbusiness purposes, such as cooking and eating. A spare room, however, that's set up as an office space and used only for business would probably meet the exclusive use test. But if the room contains a bed for the occasional overnight guest or doubles as storage space for clothing, then, technically, it wouldn't qualify.

The regular use test is generally pretty easy to pass. As long as you use your home business space for business on a frequent, continuing basis, rather than for a once-in-a-while garage sale or other sporadic business activity, you'll probably make the cut.

EXAMPLE 1: Stacey runs a hat-making business. She makes the hats in an extra room of her house in which she has a sewing machine and all her supplies, as well as a computer and a file cabinet containing her sales and other financial information. Because the only use of that room is for the hat-making business, it will meet the IRS's criteria of exclusive use. And because Stacey has made and sold hats for a couple of years, with consistent monthly sales, she'll have no trouble proving that she uses the space regularly for business.

EXAMPLE 2: Parisha has a full-time job at a plant nursery, but also does occasional freelance photography work. She has a darkroom in her basement that she uses to develop photos for her assignments. Her darkroom is dedicated to her photography business, but she spends most of her time working at the plant nursery and has only done one photo shoot in the last six months. Parisha would be ill-advised to claim her darkroom expenses as a home business deduction, because she doesn't regularly use it for business.

Exceptions to the Home Storage Exception

In its inimitable fashion, the IRS has created two exceptions to the home storage exception. First, you won't qualify for the deduction if you have an office or other business location outside your home. Second, you must store the products in a specific, identifiable space such as your garage, a closet, or extra room—not just stacked against the wall of your garage or in the corner of your basement. It's okay to use the storage space for other purposes as well, as long as you regularly use it for storing inventory or samples.

EXAMPLE: Mariana teaches ballet lessons to children at a studio in her home. She also sells instructional dance videos and regularly stores the inventory of DVDs in a large closet in her basement. Because Mariana has no other business location away from her home, she can claim a home business deduction for the basement closet. This is true even though she also stores other things in that closet such as skis and boxes of books. However, if Mariana ever opens a studio outside her home, she will not be able to deduct the expenses of the storage space.

The exclusive use rule has two exceptions: If your business use is either storing inventory or product samples, or running a qualified day care center, you don't have to meet the exclusive use test. In these two cases, the parts of the home you use for business—say, a closet for inventory storage or a living room for the day care center—may also be used for personal activities, and you will still qualify for the home business tax deduction. (See IRS Publication 587, *Business Use of Your Home*, for details. It's available online at www.irs.gov.)

Principal Place of Business

In addition to fulfilling the exclusive and regular use requirements, your home business space must be the main place where you do business—with two exceptions, as explained below in "Meeting Clients or Customers" and "Home Business in a Separate Structure." Thankfully, the principal-place-of-business rule is fairly easy to satisfy. Your home office will qualify as the principal place of business if you:

- use the office to conduct administrative or management activities, and
- do not have an office or other business location outside your home set up to conduct these activities.

This rule is just as straightforward as it sounds. As long as you use your home office to keep track of your business files, do your bookkeeping and accounting, maintain your client databases, or conduct whatever other type of administration is required, and you don't have a space away from home set up for these activities, your home office will be considered your principal place of business.

Meeting Clients or Customers

If your home office doesn't qualify as your principal place of business under the test described above, you can still qualify for the home business deduction if you regularly and exclusively use your space to meet with clients or customers. As long as you regularly use the home space to meet clients—say, once or twice a week—and don't use the space for nonbusiness purposes, you can claim the deduction for the space even if you have an office away from home.

Tips on Establishing Home Business Use

Home business owners should make an effort to clearly establish their home offices as places of business. Here are some ways you can do so:

- Take pictures of your home office that show its business character.
- Draw a diagram showing the floor plan of the house with the home office clearly defined. Include room dimensions, if possible.
- Keep a log of the times you work in the office.
- Keep a record of all client meetings at your office, including whom you met, when, and the subject of the meeting. Documenting client visits to your home office is especially important if you also have an outside office.
- Have your business mail sent to your home.
- Get a separate phone line or cell number for the business.

Home Business in a Separate Structure

Finally, another way to qualify for the home business deduction is to use an external structure on your property—a detached garage, shed, or in-law unit, for example—regularly and exclusively for your business. Again, this rule applies even if you have another business space, such as a storefront or an office, and regardless of whether you meet clients or customers there. If the space is used regularly and exclusively for business and is not physically connected to your house, you can deduct expenses for it.



CAUTION

Tax concerns for separate structures. If you use a separate structure on your property for your home business, beware of possible tax repercussions when you sell your home. When the owner uses a separate structure for business, that business portion of the property will be subject to capital gains tax when the owner sells the property. (Be sure to read "Tax Issues When You Sell Your Home," below.)

Figuring Deductible Home Business Expenses

Once you've determined that you qualify for the home business tax deduction, you'll need to figure out exactly how much you can deduct. Obviously, you can't deduct all of your housing costs—only the expenses attributable to business purposes, as defined by the IRS, will qualify.

The old standard method is to determine a "business percentage" for your home—simply, the percentage of your home that is used for business. Then you'll look at your home expenses and figure out how much of each expense may be deducted.

Now, however, you can use a new, simplified method to calculate your home office deduction: Multiply the square footage of your home office by a prescribed rate set by the IRS. We'll describe this below, after going through the old method, which is still acceptable.

Calculating Business Percentage

You can calculate the percentage of your home used for business in one of two ways: the "square footage" method or the "number of rooms" method. Either approach is acceptable to the IRS.

The square footage method simply divides the square footage of the business space by the square footage of the whole house. For instance, if you use 250 square feet for business, and your entire house takes up 1,000 square feet, then your business space uses 25% (250 ÷ 1,000) of your home.

The number-of-rooms method is just as simple: If your house has five similarly sized rooms, and you use one of them for business, then the business uses 20% (1 ÷ 5) of your home.

Categorizing and Deducting Expenses

Once you have calculated a space percentage for your business, use it to calculate the portion of your home expenses that is deductible to the business. Home expenses fall into one of three categories, with different deductibility rules for each.

Unrelated expenses. Expenses that are unrelated to your business space are not deductible at all. For example, you can't deduct the cost of repainting your bedroom or replacing your dining room window.

Direct expenses. You can fully deduct expenses that directly affect your business space, such as the cost of installing new carpeting in your office space, replacing a broken window in that room, or repairing its heating vent. Note that direct expenses for a day care center may not be fully deductible. (For more information, see IRS Publication 587, *Business Use of Your Home*, available online at www.irs.gov.)

Indirect expenses. Expenses that affect the whole house—called indirect expenses—are deductible, but only partially so, based on the percentage of your home that is used for business. For instance, you can deduct a percentage of the cost of plumbing services, roof repairs, mortgage interest, real estate taxes, and utility bills.

To calculate the portion of indirect expenses attributable to your business, you generally multiply the indirect expense by your business percentage. Rent, for example, is an easy expense to prorate. If your business uses 25% of your home, and your rent is $2,000 per month, then $500 per month is a deductible home business expense (25% × $2,000). The same simple approach generally works for calculating the deductible business portion of many other indirect expenses, such as homeowners' insurance, mortgage interest, home utilities, and repairs.



CAUTION

Repairs are generally deductible; permanent improvements are not. The IRS won't let you deduct the cost of major projects it considers "permanent improvements"—those that increase the value of property, add to its life, or give it a new or different use. The cost of repairs, on the other hand, may be deducted—either fully if a direct expense or partially if an indirect expense. The IRS defines "repairs" as those that "keep your home in good working order over its useful life." (For more details on the IRS's distinction between repairs and permanent improvements, see IRS Publication 587, *Business Use of Your Home,* available online at www.irs.gov.)

Calculating Your Deduction with the Simplified Method

The simplified method for calculating your deduction does not change any rules regarding whether you're eligible for a home office deduction. It just offers a much simpler way to calculate your deduction.

Under the new rule, simply multiply the square footage of your home office by the IRS's prescribed rate: $5 per square foot, with a maximum footage allowed of 300 square feet. It's that simple.

Note that if you use the simplified method and you own your home, you cannot claim a depreciation deduction as described below. You still may claim deductions for mortgage interest and real estate taxes, however, and you won't need to allocate these between your business and personal use.

For more information on the new simplified method, visit www.irs.gov (search for "Simplified Option for Home Office Deduction").



RESOURCE

For more on the home office deduction. For more detailed information on tax deductions for home businesses, read *Home Business Tax Deductions: Keep What You Earn*, by Stephen Fishman (Nolo).

Calculating a Depreciation Deduction

If you own your home and you qualify for the home business tax deduction, an indirect expense that you may deduct is the depreciation of your home. Depreciation of your home allows for the wear and tear inflicted upon it. And the home business depreciation deduction is simply a deduction for the business portion of this. Calculating this deduction is slightly more involved than the indirect expense deductions mentioned above. This section offers an overview of how to calculate the depreciation deduction; detailed instructions are included in IRS Publication 587, *Business Use of Your Home*, available online at www.irs.gov.

Keep in mind that depreciation is calculated for the building only—not the land. Property tax assessments usually show the breakdown of home value versus land value.

In a nutshell, calculating the depreciation deduction works like this:

1. To start, figure out the adjusted basis of your home (don't include land value) at the time you started using it for business. The adjusted basis of your home is generally its cost, plus the cost of any permanent improvements, minus any casualty losses (sudden losses from accidents such as a fire or damages from a falling tree) or depreciation deducted in earlier tax years. (The IRS explains adjusted basis in its Publication 551, *Basis of Assets*, available online at www.irs.gov.)
2. Next, figure out the fair market value of the home (again, not the land) at the time you started using the home office. The IRS defines fair market value as follows: "The price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts." Information such as appraisals or the selling price of similar homes in your area when you started using yours for business will help you determine its fair market value.
3. Next, calculate the portion of the cost of your home that can be depreciated. This amount is called the "depreciable basis." Calculate the depreciable basis by multiplying the percentage of your home used for business by the smaller of:
   - the adjusted basis of your home (excluding land) on the date you began using it for business, or
   - the fair market value of your home (excluding land) when you began using it for business. The result of this calculation—the depreciable basis—is the portion of the home's value attributable to the business.

4. Last, calculate the actual deduction that your home business will be able to claim. To oversimplify, this deduction is calculated by multiplying your depreciable basis by a certain percentage, set by the IRS. The percentage and specific depreciation method to use will depend on when you started your home business.

There are many more details involved than this book can cover, so you would be wise to consult the IRS publications before tackling the depreciation deduction on your own. Or consider handing the job over to an experienced business accountant. (See Chapter 17 for more on working with accountants and other professionals.)

Tax Issues When You Sell Your Home

Homeowners with home businesses face a couple of tax issues if they end up selling their homes: capital gains taxes and depreciation recapture. These concepts are widely misunderstood, with the result that many home business owners don't claim their rightful share of deductions for fear of the tax implications. Don't make this mistake. Not only are the rules relatively easy to understand, they're quite favorable to home business owners.

No Tax on Proportional Gain

Since 2002, when you sell your home at a gain, you do not need to allocate a portion of that gain to your home business. You can go ahead and claim all the home business tax deductions you're entitled to, without worrying that you'll be stuck with capital gains taxes for your home business portion. You'll have to pay capital gains taxes only if you exceeded the limits of $250,000 gain ($500,000 for married couples), which would apply whether or not you had a home business.

The rule that you don't need to allocate gains from a home sale to your home business has an important exception: Home businesses located in a separate structure will continue to be subject to capital gains taxes. So if you run your business from a separate, freestanding garage or shed, for example, you'll be stuck paying the gains taxes when you sell your home. To avoid this, stop claiming the home business tax deduction two years before you sell your home.

Recaptured Depreciation Tax

If you sell your home at a gain, while you do not need to allocate a portion of that gain to your home business, you are subject to what's known as "depreciation recapture." As in the past, home business owners who sell their homes must still pay taxes on the depreciation deductions they've taken over the years. In other words, if you claim depreciation deductions for a home business, the total of those deductions will be taxed—"recaptured," if you will—when you sell your house.

EXAMPLE: Patrice, a yoga instructor, sells her house at a gain of $200,000. Her home studio takes up 10% of her home. Under current IRS rules, she will not be subject to capital gains taxes for the 10% of her home used for business activities. However, Patrice must pay depreciation recapture tax on the total depreciation deductions she's taken in the five years of operating her home teaching studio.

This rule isn't really so bad when you consider the depreciation recapture rate is only 25%. Most business owners pay much more than this on income—self-employment tax at a rate of 15.3%, plus their federal personal tax rate of 15%, 28%, or higher, plus state tax rates—so that depreciation deductions can easily offer savings of 40% or more each year. The bottom line is that it's worth it to take the depreciation deductions, since you'll almost certainly save more in cumulative savings over the years than you'll end up paying when you sell your home.

Risks and Insurance

Just because you run a business from your home, don't make the mistake of taking risk management and insurance issues lightly. Home businesses are often just as vulnerable to theft, fire, personal liability claims, and other risks as businesses based in storefronts or office buildings—sometimes even more vulnerable. It can be a real catastrophe if your computer system is stolen or destroyed, or if a client trips and falls over your garden hose on the way up your front walk.

If you assume that your homeowners' policy will protect you against these risks, you may well find out the hard way that you're horribly wrong. Potentially even more important, home business owners need to make sure that none of their business pursuits jeopardize their regular homeowners' policy for non-business-related claims.



RELATED TOPIC

Start by evaluating your risks. All risk management and insurance decisions must begin with a realistic assessment of the risks your business faces. Only after you do this assessment will you be able to decide how to reduce your risks with insurance or other strategies. While some basic insurance protection for your business assets is never a bad idea, some home business owners may sensibly conclude that insurance is not necessary. (See Chapter 8.) Much of the discussion in this chapter presumes that you've decided some insurance is necessary.

This section discusses the insurance and risk management issues particular to home businesses. (Chapter 8 offers a full discussion of these topics as they apply to all businesses. Be sure to read that chapter in addition to the material below.)

Limitations of Homeowners' Policies

A common mistake among owners of home-based businesses is to assume that business losses will be covered by their homeowners' or renters' policies. This is a very dangerous assumption. While many insurance companies will extend homeowners' coverage to a home business, they'll often require an endorsement to a policy—sometimes called a "floater" or "rider"—that specifically authorizes the coverage. You'll generally have to pay an extra premium for such an endorsement. Without one, the insurance company may deny claims related to a home business.

In addition to requiring home businesses to jump through extra hoops, some insurance companies exact harsh consequences if you run a business from home without informing them first. In some cases, an insurance company may terminate your coverage altogether—even for nonbusiness claims—if it discovers that you've been running a business from your home without its authorization. This is a sobering possibility.



TIP

Honesty is the best insurance policy. You might wonder how an insurance company would find out that you are quietly operating a home business. Apart from the fact that trying to deceive your insurance company is just a foolish idea, the insurance company's suspicion can easily be aroused by claims involving major business assets such as high-end computer systems, machine equipment, or inventories that seem unsuited for home use. All it could take is a few questions or a visit from an insurance adjuster to blow your cover. When it comes to communicating with your insurer, the best advice is not to mess with the truth.

And even when homeowners' policies do cover home businesses—either with or without an endorsement—the coverage may be only for property loss, not for other claims such as liability or business interruption. If a client is injured on your slippery floor, your business might have to pay for any damages awarded in a personal injury lawsuit, without any coverage from the homeowners' policy. And if your business records are destroyed in a fire, it's highly unlikely that your homeowners' policy would cover your inability to collect accounts receivable or your lost income from business downtime.

The bottom line is that no home business owner should make the mistake of finding out what is or isn't covered the hard way. If you have homeowners' or renters' insurance, contact the providing company and find out how it deals with home businesses and what kinds of claims are covered. If you're like many home business owners, you'll likely find that your coverage isn't quite what you hoped it might be. Your next step will be to fill in those gaps, either by getting an endorsement to your existing homeowners' policy or by purchasing separate coverage.

Finding and Purchasing Insurance Coverage

An increasing number of insurance companies are willing to insure home businesses, no doubt due to the massive growth of this market. And despite what you might fear, costs are generally not prohibitive. An endorsement for a home business is typically no more than $1,000 a year—and sometimes much less. Another option is a "home-business-type" policy that's becoming more common. These are distinct from homeowners' policies but aren't quite as robust as full commercial policies, and as a result are generally a good value. Larger businesses with significant assets or risks might need to look at full commercial policies, which may be somewhat more expensive.

If you have a homeowners' or renters' policy, start your search by contacting your current insurance provider. If the carrier requires an endorsement, the process is generally a simple matter of paying an extra premium and having documents drafted reflecting the home business coverage. Of course, you'll need to check that the coverage limits are sufficient to cover the value of your

business equipment. Also find out whether liability or loss-of-income claims are covered. If not, and if these risks are a concern, you might need to purchase additional coverage.

If your current insurer doesn't offer the coverage you need, one response is to find a policy with a different company that meets your requirements. Another option, whether or not you have existing home coverage, is to look for a separate business policy. Business policies can get complicated and expensive, so it's a good idea to use a broker who can present you with options from several companies. (See Chapter 8 for general tips for buying insurance.)

Home business owners sometimes can get good deals through trade associations or other organizations that offer coverage options for their members. Organizations tend to get favorable group rates from insurance companies, so these resources are definitely worth a look.

Chapter 10 Checklist: Laws, Taxes, and Other Issues for Home Businesses

- ☐ Evaluate whether your business activities can be run well from your home.
- ☐ Find out whether any city or county restrictions apply to running a business at home—these are commonly called home occupation regulations—and obtain any necessary permits.
- ☐ To satisfy IRS requirements for the home business tax deduction, use your home business space exclusively for business and not for any personal uses. Review other IRS rules such as the "principal-place-of-business" rule to make sure your home business qualifies for the tax deduction.
- ☐ Take photos of your home business space to establish its business use.
- ☐ Do not rely on homeowners' insurance to protect you against losses related to your home business. Even more important, make sure your homeowners' policy is not voided entirely—even for personal claims—by running a business from home.

CHAPTER

11

Entering Into Contracts and Agreements

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As a business owner, you'll often have to enter into contracts with other businesses and people: clients, contract staff, vendors, creditors, and landlords, for example. While some transactions will be simple enough to complete with a handshake, many will involve details that are best put into writing and affirmatively agreed to by both parties. The higher the dollar amount involved in the transaction, the more important it is to pay close attention to the details and make sure your contract is not only binding, but also addresses likely scenarios that happen in those kinds of deals. This chapter will help point out what kinds of terms are important to include, and how to draft them into your contracts.

Thankfully—and contrary to what many people believe—a contract is often a fairly simple legal document. At its most basic, a contract is a statement of mutual promises between two parties. In the business world, this usually boils down to one party promising to do or deliver something, and the other party agrees to pay for it. If certain criteria are met (as discussed in this chapter), a legally enforceable contract is created. (The terms "contract" and "agreement" are interchangeable, and we use both in this chapter.)



TIP

Draft your contracts as a roadmap to success. A contract is your opportunity to outline your best vision of the deal you are entering. For service businesses especially, think hard about the scope of services and what you want to commit to. Remember, it's not just about putting terms in writing; it's key that your business deliver what it promises, and does so professionally and methodically.

Standard forms are readily available for many business contracts, and you might find that you can complete most without the help of an attorney.

But as simple as some types of contracts can be, you must remember that they are legally enforceable. If you fail to keep your end of the bargain, you can be sued and forced to pay damages to the other party or, in some circumstances, to do the things you promised in the contract.

This chapter explains some contract basics, including what makes a contract enforceable and which contracts are legally required to be in writing.

Elements of a Valid Contract

A contract will be valid (enforceable by a judge) if all of the following are true:

- One party has made an offer and the other has accepted it.

- Something of value, such as money, services, or goods, is being exchanged for something else of value. This exchange of value is known as "consideration." Consideration includes the promise to deliver something of value in the future.
- In a few situations, such as the sale of real estate, the agreement must be in writing. (See "Oral Versus Written Contracts," below.)

Each of these elements is described below in more detail.

Offer and Acceptance

The most basic rule of contract law is the "offer and acceptance" rule: A legal contract exists when one party makes an offer and the other party accepts it. To be valid, an offer must meet the following requirements:

- It contains sufficient details about what will be provided and at what price.
- It is made with the intention of entering into a binding agreement.
- It involves consideration (an exchange of things of value, which we discuss below).

Advertisements as Offers

Generally speaking, an advertisement to the public does not count as an offer in the legal sense. In other words, if you advertised your catering services in your local weekly newspaper, and included a price quote of $500 for your standard menu serving 20 people, you would not be legally bound to live up to that service if someone called you and said, "I accept!" If, for instance, you were too busy with other catering jobs and unable to do the job for the eager caller, you could decline. Because your ad wasn't, legally speaking, an offer, the caller couldn't claim a legal acceptance of it to create a binding contract.

Despite this, however, you do need to watch what you say in your advertisements. Some states require retailers to stock enough of an advertised item to meet reasonably expected demand, or else your ad must state that stock is limited.

Of course, false or misleading advertising is always a bad idea. Federal laws regulating trade and state consumer protection laws prohibit deceptive advertising, even if no one was actually misled. And check your ad's facts; false advertising is illegal, even if you believed the ad to be truthful when you ran it.

For most types of contracts, offers and acceptance can be made orally or in writing. (For a few, discussed in "Oral Versus Written Contracts," below, the offer and acceptance must be made in writing.)

Let's say, for instance, you're shopping around for a print shop to produce brochures for your business. One printer confirms, either orally or in writing, that he'll print 5,000 two-color flyers for $200. This constitutes his offer. If you tell him to go ahead with the job, you've accepted his offer. In the eyes of the law, when you tell the printer to go ahead, you create a contract, which means you're liable for your side of the bargain—in this case, payment of $200.

But if you tell the printer you're not sure and want to continue shopping around (or don't even respond, for that matter), you clearly haven't accepted his offer, and no agreement has been reached. Or, if you say his offer sounds great, except that you want three colors instead of two, no contract has been made, because you have not accepted all of the important terms of the offer—you've changed one. (Depending on your wording, you might have made a "counteroffer," which is discussed below.)

In real, day-to-day business, the seemingly simple steps of offer and acceptance can become quite convoluted. For instance, sometimes when you make an offer, it isn't quickly and unequivocally accepted; the other party might want to think about it for a while or try to get a better deal. And before your offer is accepted by anyone, you might change your mind and want to withdraw or amend it. Delaying acceptance of an offer, revoking an offer, and making a counteroffer are common situations in business transactions that can lead to confusion and conflict. To cut down on the potential for disputes, make sure you understand the following issues and rules:

- **How long an offer stays open.** Unless an offer includes a stated expiration date, it remains open for a "reasonable" period of time. What's "reasonable," of course, is open to interpretation and will depend on the type of business and the particular situation. Because the law in this area is so vague, if you want to accept someone else's offer, the best approach is to do it as soon as possible, while there's little doubt that the offer is still open. Keep in mind that until you accept, the person or company who made the offer—called the offeror—may revoke it.



TIP

Include an expiration date on your offer. In many types of businesses, from replacing roofs to redesigning websites, it is common to bid (in other words, to make an offer to create a contract) on lots more jobs than you really need or want. But sometimes this strategy can backfire. With lots of offers floating around, there is always the possibility

that too many will be accepted, which could raise the embarrassing possibility that you might not be able to deliver on all the work. One easy way to eliminate this problem is to print right on your bid or offer form that all offers are good for only ten days (or some other relatively short period) unless extended in writing.

- **Revoking an offer.** Whoever makes an offer can revoke it as long as it hasn't yet been accepted. This means if you make an offer and the other party wants some time to think it through, you can revoke your original offer. If your offer is accepted while it is still open, however, you'll have a binding agreement. In other words, revocation must happen before acceptance.
- **Options.** Sometimes the offeror promises that an offer will remain open for a stated period of time—and that it cannot and will not be revoked during that time. This type of agreement is called an option, and options don't usually come for free. Here's how it comes up: Suppose someone offers to sell you a forklift for $10,000, and you want to think the offer over without having to worry that the seller will revoke the offer or sell to someone else. You and the seller could agree that the offer will stay open for a certain period of time, say, 30 days. Often, however, the offeror will ask you to pay for this 30-day option—which is understandable because the seller can't sell to anyone else during the 30-day option period. As discussed below, some exchange of value—called "consideration" in legalese—is required for the option agreement to be enforceable. When an option agreement exists, the offeror cannot revoke the offer until the time period ends.



TIP

Be explicit if you want the flexibility to revoke an offer prior to its expiration date. If you include an expiration date in an offer, but want to leave room to revoke the offer before the expiration date, state so explicitly. For example, you could say that "This offer will remain open until December 31, 20xx, unless it is revoked sooner."

- **Counteroffers.** Often when an offer is made, the other party will not accept the terms of the offer right off, but will start bargaining. Of course, haggling over price is the most common type of negotiating that occurs in business situations. When one party responds to an offer by proposing something different, this proposal is called a "counteroffer." When a counteroffer is made, the legal responsibility to accept or decline the offer or make another counteroffer shifts to the original

offeror. For instance, if your printer (here, the original offeror) offers to print 5,000 brochures for you for $300, and you respond by saying you'll pay $250 for the job, you have not accepted his offer (no contract has been formed), but instead have made a counteroffer. It is then up to your printer to accept, decline, or make another counteroffer. If your printer agrees to do the job exactly as you have specified for $250, he's accepted your counteroffer and a legal contract has been formed.

Consideration: Exchange of Value

Even when both parties agree to the terms, a contract isn't valid unless the parties exchange something of value in anticipation of the completion of the contract. The "thing of value" being exchanged—called "consideration" in legal terms—is most often a promise to do something in the future, such as a promise to perform a certain job or a promise to pay a fee for that job. Returning to the example of the print job, once you and the printer agree on terms, there is an exchange of things of value (consideration): The printer has promised to print the 5,000 brochures, and you have promised to pay $250 for them.

This requirement helps differentiate a contract from generous statements and one-sided promises that are not enforceable by law. If your friend Leili offers you a favor, for instance, such as to help you move a pile of rocks without asking anything in return, that arrangement wouldn't count as a contract, because you didn't give or promise anything of value. If Leili never followed through with the favor, you would not be able to force her to keep that promise. If, however, in exchange for helping you move rocks on Saturday, you promise to help Leili weed a vegetable garden on Sunday, the two of you have a contract (and her refusal to help with the rocks would entitle you to refuse to weed her garden).

Although the exchange-of-value requirement is met in most business transactions by an exchange of promises ("I'll promise to pay money if you promise to paint my building next month"), actually doing the work or paying the money can also satisfy the rule. If, for instance, you leave your printer a voicemail message that you'll pay an extra $100 if your brochures are cut and stapled when you pick them up, and the printer does the cutting and stapling, you're obligated to pay the extra $100.

Oral Versus Written Contracts

Before you learn more about which contracts have to be in writing to be legally enforceable, here's some advice: All contracts of more than a trivial nature should be

written out and signed by both parties. Here is why:

- Writing down terms tends to make both parties review them more carefully, eliminating misunderstandings and incorrect assumptions right from the start.
- An oral agreement—no matter how honestly made—is hard to remember accurately.
- Oral contracts are sometimes difficult, and often impossible, to prove, making them hard to enforce in court.

EXAMPLE: Kay opens a plant shop called The Green Scene. Because she needs specialized grow-lights for her extensive line of tropical plants, she checks with several contractors who install lighting systems. One company, Got a Light, says it will install a system for $10,000, including the cost of the lights themselves and installation charges. That quote is the lowest among the companies Kay has checked, so she tells Got a Light she'll accept the offer, but only with a written contract.

When Got a Light sends Kay a contract, she notices that it doesn't address rewiring her shop. She calls Got a Light and talks with Dan, who tells her that she needs to have an electrician add several new circuits and provide six specialized outlets before Got a Light can install the lighting system. Had Kay and Got a Light proceeded without a written agreement, Kay might have assumed that the rewiring was included in the proposal and Got a Light might have assumed that Kay was handling it separately.

While it's good practice to put all significant contracts in writing, all states have laws that require certain contracts to be in writing. These laws often go by the name "statute of frauds" and are quite similar from state to state. They typically require the following types of contracts to be written:

- An agreement that by its terms can't be completed in a year or less. For example, a contract for a bakery to provide fresh bread to a restaurant for two years must be in writing. On the other hand, if the contract might take longer than a year to complete but could be completed within a year, it doesn't need to be in writing. For example, a contract for a gardener to landscape five big properties would not need to be written, because it is quite possible that the gardener would finish the work within one year. Similarly, a contract for a bakery to bake bread for a restaurant with no time period stated would not need to be in writing.
- A lease for a term (or time period) longer than one year, or an agreement authorizing an agent to execute such a lease on your behalf.
- Any sale of real estate (or of an interest in real estate), or an agreement authorizing an agent to purchase or sell it on your behalf.

- An agreement that by its terms will not be completed during the lifetime of one of the parties. This includes a promise to leave someone your business when you die.
- A promise to pay someone else's debt, such as a loan guarantee.

In addition to the statute of frauds laws, each state has a special body of law on commercial issues called the Uniform Commercial Code (UCC). (Although Louisiana has not fully adopted the UCC, it has implemented some of its more important provisions.) Under the UCC, a sale of goods for $500 or more requires at least a brief written note or memo indicating the agreement between the buyer and the seller. The note can be much less detailed than a normal contract; it needs only to show an agreement between the parties and the quantity of goods being sold. Other terms that are typically covered in contracts, such as the price of goods or the time and place of delivery, aren't required. This written memo usually has to be signed, although if one party doesn't object to the memo within ten days of receiving it, then that party's signature isn't required.

Now that you have an idea of which contracts must by law be in writing, it bears mentioning again that, in practice, written contracts are almost always preferable over oral ones—whether legally required or not.

Using Standard Contracts

So, how do you go about creating written contracts for your business? Luckily, virtually every type of business transaction is covered by a readily available standard contract. Service contracts, rental agreements, independent contractor agreements, contracts for sales of goods, and licensing agreements are just a few examples of blank-form contracts you should easily be able to find.

You can find blank-form contracts (also known as agreements) in books and online. Once you find the contract you need, you simply fill it in and, if necessary, modify it before signing. Of course, it's critical to review form contracts and sample agreements closely and consider the sources sharing them. These forms should be considered a starting point, not a solution to just copy and use.

AI Contract Tools

At the time this book is being written, AI tools to analyze and even draft contracts are being marketed. The likely customers for these early applications are law firms and bigger businesses. We can't recommend those tools for small businesses yet, but we do suggest that you keep an eye on the market for AI contract tools that might work for you.

Special State Requirements for Contracts

Various state laws impose additional requirements for contracts involving particular businesses or certain kinds of transactions. In California, for instance, contracts for weight-loss services and dating services must be in writing. Plus, the law requires some contracts to include special language. For example, California dating service contracts must include the following language in at least 10-point boldface type:

> **"You, the buyer, may cancel this agreement, without any penalty or obligation, at any time prior to midnight of the original contract seller's third business day following the date of this contract, excluding Sundays and holidays. To cancel this agreement, mail or deliver a signed and dated notice, or send a telegram which states that you, the buyer, are canceling this agreement, or words of similar effect." (Cal. Civ. Code § 1694.2.)**

Unfortunately, no centralized database exists where a business owner can learn if any special contract laws apply to a particular type of business. Talk with people in your line of business, do research online, and, if necessary, consult an attorney.



RESOURCE

Nolo books offer many different agreements, and Nolo.com includes many single-copy forms such as promissory notes. For general business contracts, a great resource is *Legal Forms for Starting & Running a Small Business*, by Fred S. Steingold.

Once you've found a contract that generally fits your needs, you can amend it for your situation. It's entirely appropriate and often necessary to change clauses of a fill-in-the-blanks contract to suit your needs. Of course, it's crucial that you understand what you're doing. Don't just strike a clause because you don't understand what it means or add a clause without fully knowing the consequences of including it. To help you educate yourself about typical contract language, the next section explains clauses that commonly appear in contracts.

How to Draft a Contract

If you can't find a form agreement, or if you find one that needs a load of revisions, you might need to write a clause or two—or possibly even the whole contract—from scratch. Don't be intimidated. Either way, your goal is simple: to state clearly what

each party is agreeing to do and the specifics of how they'll do it (usually called the terms of the contract). Put another way, your written contract should be the most accurate reflection possible of the understanding you have with the other party.

This section explains the important things to include in most contracts and alerts you to the situations that might require more specialized provisions. The information provided here will help you in editing or drafting amendments to a standard contract, or in drafting a contract from scratch, if necessary. You'll also find examples of how to state certain terms—although, as mentioned above, clear English is really all that's usually necessary. For an in-depth explanation of contract terms and sample clauses you can adapt to fit your needs, see *Contracts: The Essential Business Desk Reference*, by Richard Stim (Nolo).



TIP

Don't get *too* specific. Although a good contract covers all the important aspects of a deal, you don't need to specify every tiny detail. For instance, if you hire a cleaning service, it would be overkill to specify the type of vacuum or mops they will use. Better to put your energy into picking the right person or company to do the job and to leave most specifics of the actual work up to those who will do it. In deciding how much detail is enough, you'll simply have to judge for yourself which nitpicky details are so important that they should be covered in your contract, and which ones you can safely ignore. For example, it would be appropriate to specify nontoxic cleaning products if you're sensitive to certain chemicals. In short, don't micromanage in your contracts.

What to Include in a Basic Contract

So you've reached an agreement with another party and are ready to put it into writing. Before you start editing a form contract or writing one on your own, step back a moment to consider that the goals of all contracts are to:

- clearly outline what each party is agreeing to do (including timelines and payment arrangements)
- anticipate areas of confusion or points of potential conflict, and
- provide for recourse (a remedy) in case either side does not follow the contract through to completion.

The more you have at stake, the more carefully you should approach the task of putting together your contract. For example, if you're entering into a contract with a handyman to put up some cubicle walls in your office, you won't need your agreement to be outlined nearly as meticulously as you would in a contract for the construction of a building.

Good Ideas to Keep Your Contracts Crystal Clear

- Avoid the use of "he," "she," "they," or other pronouns in your contracts, as they can easily lead to confusion over what parties you're talking about. Use either the actual names of the parties or their roles, such as "Landlord" and "Tenant." It might seem repetitive or clumsy to write this way, but your goal is to be clear—not to write beautiful prose.
- Stay away from legalistic words such as wherefore, herewith, or hereinafter. Far from making your contract sound more impressive, this type of language is simply unnecessary and outdated. Stick to modern, clear English. And don't include legal expressions you think you have heard elsewhere. Legal-sounding jargon will not make your contract more binding—and if you get it wrong, you could be bound to terms you didn't want, or your contract could be at risk of being unenforceable.
- Make at least a couple drafts of your contract. After the first draft, let it rest a day or so, and then reread it. Does it leave any questions in your mind? If it does, you need to fill in the gaps with more information.
- Ask someone else—a business partner, an employee, your spouse, or a friend—to read the contract. Ask whether it's understandable and whether you've defined key terms. A fresh set of eyes can spot problems that someone intimately familiar with the words might miss. Heed the importance of fixing typos—many a contract has stumbled over a misplaced or missing comma.



SEE AN EXPERT

For complex agreements, consult an attorney. Complex contracts—especially those in areas unfamiliar to you—are often best handled with the help of a lawyer. Certainly, if a transaction is so huge or elaborate that it makes your head spin, you shouldn't go it alone. First, decide how much help you need. Rather than having an attorney draft your contract from start to finish, you could simply have an attorney review a contract that you or the other party has written. Ideally, you should hire a lawyer with some experience with small business, preferably your type of business. Even better would be an attorney who knows the ins and outs of your business based on a long-term working relationship. (See Chapter 17 for more information on getting legal assistance.)

Let's look at the information that most contracts include to fulfill these three goals. Except where noted below, you don't need to use any special language:

- **Title.** Generally, a contract will have a simple, to-the-point title such as "Contract for Printing Services" or "Agreement for Sale of Ball Bearings."
- **The names and addresses of all the parties.** It should be clear what role each party has in the contract, such as seller or buyer; landlord or tenant; client or service provider.

  EXAMPLE: Erica Griego ("Client") desires to enter into a contract ("contract") with Virgil's Printing ("Printer") for printing services for Client's newspaper.

Following each side's name, designate a word or phrase that will stand for that party. Above, Erica will be referred to throughout the contract as Client. This saves you the trouble of typing out her whole name every time she is the subject or object of a clause. The addresses of the parties generally appear at the end of the contract, in the section with the signatures.

- **A brief description of the background of the agreement (called "recitals").** While not always included, this type of information is often necessary to frame the contents of the agreement. Typically, this section includes a brief description of what kinds of businesses the parties run and the nature of the transaction covered in the contract.

  EXAMPLE: Client produces and distributes a free, weekly, 24-page newspaper called *El Norte* with a circulation of 40,000. Printer operates a full-service print shop. The subject of this Contract is an agreement that Printer shall print Client's newspaper each week in exchange for payment.

- **A full description of what each party is promising to do as part of the agreement.** This section, sometimes called the "specifications" or just "specs," describes the terms of the deal. If a product is being sold, describe the product and delivery terms. If a service is being performed, describe the job and then state when it will be completed, including any intermediate deadlines that must be met before the final completion date. If strict compliance with deadlines is necessary, throw in the phrase "Time is of the essence." This is a standard phrase used in contracts. It simply means that deadlines will be enforced strictly.

  If specifications are complicated (for example, intricate performance details for a software contract), they should normally be set out in attachments to the contract. Attachments often include scale drawings, formulas, or other detailed information about the transaction.

  EXAMPLE: Client promises to upload PDF files ("Files") for printing to Printer's server no later than 10:00 a.m. each Wednesday morning. Printer promises to print, fold, and bundle 40,000 copies of Client's newspaper and have them ready for Client to pick up from Printer's shop by 8:00 p.m. that same Wednesday. Time is of the essence regarding this contract. If, however, Client fails to upload Files to Printer by 10:00 a.m. Wednesday morning,

Printer may take extra time to complete the job. The amount of extra time will depend on how late Client is in uploading the Files and on Printer's schedule of other jobs, but in no case shall be longer than 24 hours after uploading of the Files.

- **The price of the product or service.** This section states how much one party will pay for the other party's goods or services. If the price will vary (say, based on the time or quality of performance) or if it will be established later, a description of how it will be calculated should be included.

  EXAMPLE: The cost of Client's print job will be calculated from a Base Rate of $5,000 for 50,000 24-page newspapers. If Client orders a different number of newspapers, or different page counts, the price will be adjusted per the Pricing Chart on Attachment A.

- **Payment arrangements.** This section should explain when payment is due, whether it will be paid all at once or in installments, and whether interest will be charged if payments are late. Also include any other special requirements, such as whether payment must be by certified or cashier's check. Otherwise, a garden-variety check will normally suffice. Again, if strict compliance with payment deadlines is necessary, use the phrase "Time is of the essence."

  EXAMPLE: Client will pay Printer the full amount of each week's printing cost within three days of picking up the completed newspapers.

- **A statement of any warranties made by either party regarding the product or service being provided.** A warranty is essentially a guarantee made by one party to another that a product or service will meet certain standards. If either party gives a warranty, the contract should state what will happen if the guarantee isn't satisfied—for instance, if certain standards aren't met, the party who got the raw end of the deal will be given a refund or may give the other party another chance to do the job right at no additional cost.

  EXAMPLE: Printer warrants that the completed newspapers shall be free from printing defects or errors attributable to Printer. In case such errors do occur, Printer and Client will negotiate a discount not to exceed actual damages suffered by Client.

Automatic Warranties

Under the Uniform Commercial Code, which is adopted in some form in all 50 states, all sales of products are automatically covered by some warranties whether or not the seller promised anything to the buyer. These warranties are called "implied warranties" and include two guarantees: that the product is fit for its ordinary use and that it is fit for any special purpose for which the seller knows the buyer wants to use it. For example, the sale of a kitchen knife comes with an implied warranty that the knife will work in ordinary kitchen uses. If the buyer asked the retailer to help pick out a knife that would cut through heavy beef bones, then whatever knife the retailer sold would come with a warranty that it would work for cutting heavy beef bones. This is true regardless of whether or not the knife came with an express, written warranty that it could be used for heavy butcher work.

Be aware of the existence of implied warranties when drafting your contracts. Even if you don't make specific promises in your contracts, you will still be legally bound by the two kinds of implied warranties described above: fitness for ordinary use and fitness for a particular purpose. The law regarding warranties can be complex. You may want to consult an attorney for more detailed information about your obligations as a seller.

- **A statement of whether either party may transfer the contract to an outside party.** Transferring contract rights is also called assigning. If you have chosen a company to provide products or services because of particular characteristics, such as good personal service or artistic detail, you might not want that company to be able to hand off the job to someone else, who might not do as good a job.

  EXAMPLE: Neither Printer nor Client may assign this Contract or any part of it to another party.

- **The contract term.** This section establishes how long the contract will be in effect.

  EXAMPLE: This Contract will commence on the date it is signed by both parties, and will remain in effect for a period of one year, or until it is terminated by one of the parties, whichever is first.

- **A description of any conditions under which either party may terminate the agreement.** It's not uncommon to allow either party to terminate the contract with a certain amount of notice, say, 30 or 60 days. Some lawyers call this "termination for convenience" since it essentially allows the parties to terminate for any reason whatsoever, no questions asked.

> **EXAMPLE:** Either Printer or Client may terminate this Contract upon 30 days' written notice. Email notice is sufficient for this provision.

Sometimes you and the other party won't want to give each other a "no fault" termination right. But whether you include this convenient escape hatch or not, you'll definitely want to mention the "for cause" termination right that each side will have. Known as "termination for cause," it gives each side the right to walk away under circumstances such as insolvency (a party goes bankrupt) or when the other side has seriously broken ("breached") the contract.

> **EXAMPLE:** Either Printer or Client may terminate this Contract effective immediately if the other party (i) commits any material breach or default of this Contract and does not remedy such breach within 30 days of receiving notice from the other party; (ii) becomes the subject of any voluntary or involuntary proceeding under the U.S. Bankruptcy Code or state insolvency proceeding and such proceeding is not terminated within sixty (60) days of its commencement; or (iii) ceases to be actively engaged in business and has not assigned this Contract.

No matter which reasons you allow for termination, you should include language clarifying how you will handle payments for services performed but not yet paid for, or for payments made for services not yet performed.

> **EXAMPLE:** If upon termination of this Contract, either party has provided services that have not yet been paid for, or payments for which services have not yet been performed, the parties agree to provide payments or refunds based upon a good-faith estimate of the pro rata value owed to the other party.

- **An outline of how you will deal with a breach-of-contract situation.** Though signing a contract might not head off a subsequent dispute, a contract can channel the dispute in ways that will allow it to be resolved as quickly and cheaply as possible. You can take a number of different approaches.

  You can decide, in advance, the amount of damages (financial compensation) a breaching party will have to pay to avoid the often lengthy and contentious process of calculating a party's damages after the other party breaches the contract. When damages are preset in a contract, they are called liquidated damages. In order for a liquidated damages clause to be valid, the dollar amount of damages that you set must be a reasonable estimate of what actual damages would be, not merely a preset penalty for breaking the contract.

Another option is for both parties to agree in the contract to try mediation and, if that fails, to use arbitration as alternatives to going to court.

> **EXAMPLE:** If any dispute arises under the terms of this Contract, the parties agree to select a mutually agreeable, neutral third party to help them mediate it. The costs of mediation will be shared equally. If the dispute is not resolved after 30 days in mediation, the parties agree to choose a mutually agreeable arbitrator who will arbitrate the dispute. The costs of arbitration will be assigned to the parties by the arbitrator. The results of arbitration will be binding and final.

If one or both of you prefer going to court, you can provide in the contract that the losing party in a dispute must pay the other party's legal fees; or you can establish that each party is responsible for individual legal fees regardless of who prevails. Note that for some commercial transactions, neither party in a lawsuit can collect attorneys' fees from the other unless it is provided for in a written contract.

- **For contracts with out-of-state entities, a statement of which state's laws apply to the transaction.** Although contract law in all states is very similar, using the law in your state will generally be the simplest for you, because you'll have more resources at your disposal, including law libraries and local attorneys.

> **EXAMPLE:** This Contract is governed by and interpreted under the laws of New Mexico.

- **Signatures, dates, and addresses.** Your signature section should always include room for the date the contract was signed, as well as the addresses of the parties.

Entrepreneur's Insight

Jennifer F. Mahoney, owner of an illustration service in Northern California

My creativity is exercised just as much by drawing up a good agreement with a client as it is by the way I create art for that client.



RESOURCE

More on business contracts. For detailed advice on how to write contract provisions, find out what a particular contract term such as indemnity means, or for sample contract clauses you can use, see *Contracts: The Essential Business Desk Reference*, by Richard Stim (Nolo).

Putting Your Contract Together

In addition to making sure your contract includes all the necessary information, you'll need to present it in an easy-to-follow, professional format. Generally, contract clauses are organized in numbered paragraphs for easy reference to specific terms.

If your agreement includes any hard-to-articulate details, such as the specifications of a software product, a drawing of a company logo, or architectural blueprints, you can include them as attachments to the main contract. If you include an attachment, be sure to label it and refer to it in the main contract. To officially make it a part of the contract, state somewhere in the main contract that you "include the Attachment in the contract" or that you "incorporate the Attachment into the contract."

EXAMPLE 1: Company agrees to pay Artist $100 for use of logo. Logo is attached to this Contract as Attachment A and is included in this Contract.

EXAMPLE 2: Contractor agrees to complete remodeling within one year. The final plans are attached to this Contract as Exhibit B and are incorporated into this Contract.

Reading and Revising a Contract

If you don't like certain terms of a contract that's presented to you, you can propose changes. By doing this, you are technically making a counteroffer.

Contracts are commonly negotiated back and forth (offer and counteroffer) until all the terms are accepted by both parties. Remember, if the parties aren't in agreement, there's no contract—oral or otherwise.

Parties can make changes to a contract —whether to a form contract or one drafted from scratch—in a number of ways. You can simply cross out language and fill in new language directly on the contract itself. Both parties should initial any such changes to show that they approve of them, then sign the contract as a whole.

In today's world, however, it's more than likely that an electronic copy of the contract will be on someone's computer. If so, it makes much more sense to make the necessary changes directly in the digital file and then print out a clean copy for both parties to sign. However, some industries (such as the real estate industry) commonly use a separate document when making a counteroffer that states the desired changes and refers back to the original offer. In that case, both the original offer and the counteroffer together form the contract.

A contract can also be amended at a later date with a separate document, called an addendum. The addendum should state that its terms prevail over the terms of the original contract, especially if the terms are in direct conflict, such as when the price or completion time for a job is changed. Both parties should sign the addendum.



TIP

Don't be afraid to redraft contract language. When reading a contract that has been presented to you, your first task is to make sure you understand all of its terms. It is just plain foolish to sign a contract if you're unclear on the meaning of any of its language. If a clause is poorly written, hard to understand, or doesn't accomplish your key goals, rewrite it to be clear. By refusing to sign at the "X" unless your goals are clearly met, you'll be less likely to find yourself in a breach-of-contract lawsuit later on. A breach of contract occurs when one party fails to live up to the terms or promises in the contract. (For more on changing contract language, see "Reading and Revising a Contract," above.)

Electronic Contracts and Signatures

Under state law and federal law, electronic contracts and electronic signatures are as legal and enforceable as traditional paper contracts signed in ink. Basically, any agreed-upon method for providing the e-signature will suffice—for example, typing the signer's name into the signature area (often with some grammatical "bookends" (for example /Robert Smith/ or "Robert Smith") or pasting in a scanned version of each signer's signature.

You can also use a service like DocuSign or Adobe Sign to exchange encrypted forms and digital signatures.

Be aware that an offer can be made and accepted via email or text, so a contract can be formed by such an exchange. If you're emailing or texting with the other side in a potential business deal, be clear that you do or do not want those communications to constitute a legally-binding agreement.

Chapter 11 Checklist: Entering Into Contracts and Agreements

- ☐ Become familiar with the legal basics of contracts.
- ☐ Put all your contracts into writing whenever possible. (Contracts created online or by email are considered to be "in writing.")
- ☐ Try to respond to offers promptly, and, when making an offer, include an expiration date.
- ☐ When you need to draft a contract from scratch, try using standard form contracts to get started.
- ☐ Be thorough in your contracts. Make sure that any points of potential conflict are clearly spelled out.

CHAPTER

12

Your Back Office: Accounting and Technology

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Keeping good books, managing finances, and using technology effectively are essential to the success of your small business. In this chapter, we look at your back office systems—accounting and technology.

Accounting

Perhaps the hardest part of accounting is getting over the psychological hang-up that most people seem to have about it. Many of us hate to balance our checkbooks on a regular basis, much less keep detailed accounts of how our money comes and goes. In truth, you don't need to be a financial wizard to start a small business; you just need a comfortable working knowledge of the basics.

If you read Chapter 4 on writing a business plan, some of this material might be a review. That chapter explained how to generate financial projections using sales and expense estimates to see if your business is likely to turn a profit. The financial tools used in business planning—particularly profit/loss analysis and cash flow projection—are the same tools used in accounting, just employed slightly differently. Instead of making financial projections, we'll focus on how to track actual, current financial data for your business.

This chapter will give an overview of what's involved in bookkeeping and the basic concepts business owners need to understand. We'll explain the receipts and records that your business should keep, and describe simple ways to organize them. We'll also explain how bookkeeping software works, including setting it up, entering your income and expense data, and generating reports showing how well (or poorly) your business is doing financially. Generating reports from your income and expense data will also help you manage the cash that flows through your business, so that you can pay your important bills on time.

While this chapter provides important, basic financial management information that every business owner should understand, keep in mind that it often makes sense to use a professional bookkeeper to handle data entry and financial management tasks. Retail stores, for example, with dozens or hundreds of transactions every day, would likely want to have a part- or full-time bookkeeper on staff to keep the books continually updated. Smaller businesses like consultants or freelancers might simply do the data entry themselves, or contract with a bookkeeper to do data entry periodically, say, once a month. And even if you plan to do all the data entry and financial management yourself, it's still a good idea to have at least a consulting session or

two with an experienced bookkeeper when you start your business. An experienced bookkeeper can be a huge help in getting off on the right foot, from clarifying the records you should keep to setting up your bookkeeping software and teaching you how to use it.

Fortunately for today's entrepreneurs, inexpensive, powerful, and easy-to-use software vastly simplifies financial management tasks. Programs such as *Quicken* and *QuickBooks* have several different versions to meet the needs of all sizes and types of businesses, making this once unsavory task much more palatable. Once your income and expenses are entered into the software, you can easily generate sophisticated financial reports that would have taken many hours and considerable skill to create just a decade ago. In fact,

Bookkeepers and Accountants: What Is the Difference?

In a nutshell, bookkeepers specialize in the day-to-day tasks of tracking a business's income and expenses, often being in charge of data entry and generating reports such as monthly profit/loss statements (explained later in this chapter). In addition, bookkeepers are often hired to prepare payroll (including determining how much tax to withhold from employees' checks, issuing the checks, and managing payroll tax deposits), file statements for property or unemployment taxes, and related bureaucratic tasks.

Accountants, on the other hand, specialize in making sense of your financial data and handling tasks such as filing tax returns and managing tax-savings strategies for businesses. Accountants can analyze your financial data and give advice on questions such as whether it's a good time to expand your business, or how to set up employee benefits to maximize tax savings. Because accountants typically have deeper knowledge of tax rules than bookkeepers, they are usually better at answering any gray-area tax questions, such as whether certain types of transactions are subject to state sales tax. (See Chapter 17 for more information on different kinds of accountants, such as certified public accountants.)

There's typically a big cost difference between accountants and bookkeepers—accountants usually charge significantly more—so you'll want to hire the right ones for the right tasks. Most small businesses should hire an accountant at least once a year to prepare the business's tax return. (Tax basics are discussed in Chapter 9.) For smaller, day-to-day tasks and routine filings, you'll be better off hiring a bookkeeper. Bookkeepers can also be a big help in establishing an effective record-keeping system, including choosing the best financial management software for your business, setting it up, and showing you how it works.

bookkeeping software is so affordable and user-friendly, it really doesn't make sense to track your finances manually in spreadsheets or other old-school methods. When your income and expenses aren't in a system that can easily generate reports, your ability to handle many important tasks like tax filings or applying for loans will be seriously hampered.



CAUTION

Report cash payments above $10,000. You need to let the IRS know when you receive a large cash payment: People in a trade or business have 15 days to report receiving more than $10,000 in cash in one transaction or related transactions. A "transaction" includes purchasing property or services, paying debt, and even holding cash for someone for more than 15 days as part of a deal. "Cash" includes any combination of U.S. and foreign coins and bills and a cashier's check, money order, bank draft, or travelers' check (but not a personal check) with a face amount of $10,000 or more—unless it comes from a bank loan. To report, the business owner must file Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, with the IRS and the Financial Crimes Enforcement Network (FinCEN). Breaking up one transaction into many little ones to avoid this reporting requirement can lead to prison and heavy fines. Check with your accountant or lawyer if you find yourself with this kind of cash.



TIP

Don't expect accounting software to do all your work for you. You shouldn't simply rely on the numbers that your software program spits out if you don't fully understand them. The accounting concepts and processes described in this chapter are the same whether done manually or by accounting software—and you should take the time to learn them. Though accounting software makes it much easier to manipulate the numbers you've entered and to generate informative financial reports, you still need to understand what all the numbers mean in order to use them to make meaningful business decisions.

Accounting Basics

If you are intimidated or just plain overwhelmed by the prospect of managing your business's finances, it can be helpful to get back to basics and consider the big picture. Carefully tracking income and expenses helps you in the following ways:

- **You'll improve your chances of making a profit.** Having a firm handle on your income and expenses is essential to making smart business decisions that lead to profitability.
- **You'll have well-organized financial information that is necessary to file your various tax returns and local tax registration papers.** There's no

Accounting Glossary

A big part of understanding the financial side of your business consists of nothing more than learning the language of accounting. Once you're familiar with some common terms, such as the ones listed below, you'll be better able to make sense of basic written reports and to communicate with others about important financial information. And you'll also be well positioned to cope with a common business problem: people who use key financial terms imprecisely or even incorrectly, needlessly confusing themselves and others:

- **Accounting** refers to the process of tracking your business's income and expenses, then using these numbers in various calculations and formulas to answer questions about the financial and tax status of the business.
- **Bookkeeping** refers to the task of recording the amount, date, and source of all business revenues and expenses. Bookkeeping is the starting point of the accounting process. Only with accurate bookkeeping can there be meaningful accounting.
- An **invoice** is a written record of a transaction, often submitted to a customer or client when requesting payment. Invoices are sometimes called *bills* or *statements*, though statement has its own technical meaning. (See below.)
- A **statement** is a written summary of an account. Unlike an invoice, a statement is not generally used as a formal request for payment, but is used to outline the details of an account.
- A **ledger** is a somewhat old-fashioned term referring to a collection of related financial information, such as revenues, expenditures, accounts receivable, and accounts payable. Ledgers used to be kept in books preprinted with lined ledger paper (which explains why a business's financial information is often referred to as the "books"), but are now commonly kept electronically using various software programs.
- An **account** is a collection of financial information grouped according to customer or purpose. For example, if you have a regular customer, your information regarding that customer's purchases, payments, and debts would be called their "account." A written record of an account is called a *statement*.
- A **receipt** is a written record of a transaction. Buyers receive a receipt to show that they paid for an item. Sellers keep a copy of the receipt to show that they received payment for the item.
- **Accounts payable** are amounts that your business owes. For example, unpaid utility bills and purchases your business makes on credit are included in your accounts payable.
- **Accounts receivable** are amounts owed to your business that you expect to receive, including sales your business makes on credit.

worse nightmare than facing a tax deadline and having months' worth of unorganized receipts that haven't been entered into your record-keeping system (or worse yet: not having a record-keeping system in place at all).

Sounds pretty simple, no? All the intricacies of financial management basically boil down to these two points. You should also be reassured to know that you're not legally required to keep your records in any particular organizational system. Some businesses are legally required, however, to use a certain method of crediting their accounts. (See "Cash Versus Accrual Accounting," below.) In other words, there's no official system or format to organize your books. As long as your records accurately reflect your business's income and expenses, the IRS will find them acceptable.



TIP

Organization is everything. One thing that all good bookkeeping systems have in common is organization. A well-organized system with accessible, reasonably neat files (including both hard-copy and electronic records) not only will be a godsend in the event of an audit, but will help you keep track of your business as well.

Benefits of Well-Maintained Financial Records

Are you beginning to believe that you don't need to be afraid of financial management? Good, because it's something you absolutely need to embrace as part of running any business. Failing to keep track of income and expenses is one of the surest ways to run any business off a cliff. Here are a few more details on how a well-maintained bookkeeping system will help your business:

- **You'll be able to price your goods and services more competitively.** Only by staying on top of your business's income and expenses will you know how much money you'll need to bring in each week, month, or year to make a profit. This knowledge is essential to allow you to price your goods and services appropriately. For instance, if you don't know your break-even point, you will only be able to guess at how much you should charge your customers for products or services, with the likely result that you'll charge too little (and make an inadequate profit) or too much (and alienate customers).
- **You'll be able to trim costs strategically.** Having updated and categorized expense data will allow you to see

your spending patterns and spot areas where you can reduce your costs to improve your bottom line. For example, you might see the need to cut back on travel expenses or on outsourced services that aren't sufficiently helping generate income.

- **You'll be able to pace your growth more effectively.** A good set of books will give you the information you need to decide when and how to expand your business. If your numbers tell you that sales and profits have been growing consistently for several months, that might be a signal that it's time to hire additional employees or enter into a new market—or both. Without meaningful financial numbers, making any decisions about growth can be a gamble. For example, just because your business has a lot of money in its checking account doesn't necessarily mean you're making good money. (You might have received several big payments from past sales, while current sales are actually slowing down.)
- **You might be able to reduce taxes.** Knowing your company's finances inside and out will help you save money when tax time comes around. For example, if the end of the year is nearing and your up-to-date records clearly show the year to be profitable, you can purchase needed supplies or equipment before the end of the year and write off these expenses, reducing your taxable income. Also, keeping careful track of your expenses will remind you to claim them as deductions at year-end. Businesses that are sloppy about bookkeeping often miss opportunities for saving tax dollars. Don't be one of them.
- **You'll avoid tax penalties.** In addition to helping you legally save tax dollars, responsible bookkeeping will help you avoid errors in your tax returns that can subject you to fines and other penalties. If your business is audited, the IRS can be really nasty if it finds your books in bad shape. In extreme situations, it may even refuse to recognize perfectly legitimate expenses. In short, neglecting your responsibility to maintain basic, accurate records is likely to result in the kind of trouble with the IRS that you might not wish on even your worst enemy.
- **You'll be well positioned to apply for loans or grants.** Small business assistance programs have increased since 2020, notably the Payroll Protection Program loans that the federal government rolled out to help businesses affected by COVID. If your books aren't in order, it will be difficult or impossible to apply for these funds.

The Financial Management Process

At the most basic level, you can break down the process of financial management into three broad steps. We'll discuss these in more detail later in the chapter; for now let's just look at an overview:

1. **Keep records.** The process starts with keeping records (basic receipts, usually) of all the money the business spends (expenses) and all the money it earns (income). This means carefully keeping and organizing your expense receipts (that is, receipts from the office supply store, bills from your accountant and lawyer, records of payments to your employees and freelancers, and so on) and your income receipts (such as a cash register tape of your clothing store's income, check stubs from your client's payment checks, or your invoices to clients marked "Paid").
2. **Enter information into a bookkeeping system.** Next, on some periodic basis—say, monthly for a small consulting business, or daily for a busy retail store—you'll enter the information from the income and expense receipts into a bookkeeping system. More often than not, this will be some sort of financial management software such as *QuickBooks*. (In the old days, this was done by entering the income and expenses into a ledger.)
3. **Generate financial reports.** Finally, with up-to-date information entered into your bookkeeping system, you'll generate reports such as a profit/loss report or an accounts receivable report to reveal how your business is doing. These reports summarize the data you've entered to show you different aspects of your business's financial situation. For example, a profit/loss report shows whether you made a profit in a given time period (usually monthly), while an accounts receivable report shows how much your clients owe you at any given time. Generating reports should be done on a periodic basis, with some reports following different schedules than others. For example, most businesses should generate a profit/loss report each month, as well as quarterly and annually.



CAUTION

Do not neglect to open a business bank account! Using your personal bank account for business deposits and expenses is a huge mistake for a number of reasons. One is that if you hoped to protect your personal assets by creating an LLC or a corporation, you'll basically throw this protection out the window by commingling personal and business funds. And on a more important day-to-day level, mixing your business transactions with personal

transactions will make it impossible to do the types of simple financial management described in this chapter. Run, do not walk, to your local community bank and open a business bank account as soon as you're ready to launch.

Cash Versus Accrual Accounting

Before turning to several simple systems for keeping your records, you need to understand the two principal methods of keeping track of a business's income and expenses: cash method and accrual method accounting (sometimes called cash basis and accrual basis accounting). In a nutshell, the difference between these methods has to do with the timing of when transactions—both sales and purchases—are credited to or debited from your accounts. In short:

- Under the cash method, income is counted when cash (or a check) is actually received, not necessarily when the sale occurs; expenses are counted when they are actually paid, not necessarily when you made the purchase.
- Under the accrual method, transactions are counted when they happen—for example, when you complete a sale, or make a purchase—regardless of when the money is actually received or paid. You don't have to wait until you receive the money, or until you actually pay money out of your checking account, to record the transaction.

For example, say you hire a branding firm to redesign some of your product packaging, and they complete the new designs and all other terms of the contract in mid-December 2024. The contract specifies that you will pay within 30 days of project completion and invoice, so you pay the full balance of $2,500 in mid-January 2025. Using cash method accounting, you would record a $2,500 expense in January 2025, when the money was actually paid. But under the accrual method, the $2,500 payment would be recorded in December 2024, when the job was completed and you became obligated to pay for it. Similarly, if your IT management business finished a job in November 2024 and didn't get paid until January 2025, you'd record the payment in January 2025 if you used the cash method. Under the accrual method, the income would be recorded in your books in November 2024.

Note that expenses paid with a credit card can be deducted at the time when incurred. The IRS allows a business to take deductions for business credit card purchases before you've paid the credit card bill, even if you're using cash basis accounting. For more details on this and other exceptions and gray areas, talk with a bookkeeper.



TIP

Timing can be tricky. Some sales aren't completed all at once. If you use accrual accounting, you might sometimes wonder exactly when you can enter the transaction into your books. For instance, say someone buys two CDs from your record store but also makes a special order for another CD, and pays for all three at once. Or, say your landscaping company finishes a large project, except for the last step of applying a final lawn fertilizing treatment two weeks after laying the sod. The key date here is the job completion date. Don't count the transaction until you deliver all of the goods, finish all parts of a service, or otherwise meet all terms of a contract. If a job is mostly completed but will take another few days to add the finishing touches, it doesn't go on your books until it is completely done. In situations like these, the help of an experienced bookkeeper can be a godsend.



TIP

Each method can produce the same results. As you can see, the results produced by the cash and accrual accounting methods will be different only if you do some transactions on credit. If all your transactions are paid in cash as soon as completed, including your sales and purchases, then your books will look the same regardless of the method you use.

Accounting Methods and Taxes

The most significant way your business is affected by the accounting method you choose involves the tax year in which income and expense items will be counted. (See "Tax Years and Accounting Periods," below.) For instance, if you use the cash method, and you incur expenses in the 2024 tax year but don't pay them until the 2025 tax year, you won't be able to claim them on your 2024 tax return. But you will be able to claim them in 2024 if you use the accrual method, because that system records transactions when they occur, not when money actually changes hands.

EXAMPLE 1: Zara runs a small flower shop called ZuZu's Petals. On December 22, 2024, Zara buys a number of office supplies for which she will be billed $400. She takes the supplies that day but, according to the terms of the purchase, doesn't pay for them for 30 days. Under her accrual system of accounting, she counts the $400 expense during the December 2024 accounting period, even though she didn't actually write the check until January of the next year. This means that Zara can deduct the $400 from her taxable income of 2024.

EXAMPLE 2: Scott and Lisa operate A Stitch in Hide, a leather repair shop. They're hired to repair an antique leather couch, and they finish their job on December 15, 2024. They bill the customer $750, which they receive on January 20, 2025. Because they use the accrual method of accounting, Scott and Lisa count the $750 income in December 2024, because that's when they earned the money by finishing the job. This income must be reported on their 2024 tax return, even though they didn't receive the money that year.

Tax Years and Accounting Periods

Income and expenses must be reported to the IRS for a specific period of time, alternately called your "tax year," "accounting period," or "fiscal year." Unless you have a valid business reason to use a different period, or unless your business is a corporation, you'll have to use the calendar year, beginning on January 1 and ending on December 31. Most business owners use the calendar year for their tax years, simply because they find it easy and natural to use. But if you want to use a different period, you must request permission from the IRS by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year.* Your fiscal year can't begin and end on just any day of the month; it must begin on the first day of a month and end on the last day of the previous month one year later.

Which Method to Use

In choosing a method, first consider the IRS rules that may dictate your choice. The general rule as of 2018 is that corporations and partnerships with average annual gross receipts for the three preceding tax years of $25 million or less (indexed for inflation) qualify as a "small business" and can use the cash method. Note that the rules for accounting for inventories can be slightly more complicated than those explained here, so it's a good idea to ask an accountant for advice.

Perhaps even more important than the IRS rules is to consider which method will give you the most control over your business's finances. In general, the cash method is simpler and could be the best route for freelancers and small firms. However, the cash method does not give as accurate a picture of your operational profitability as does the accrual method. Under the cash method, for instance, your books could show a three-month period to be spectacularly profitable because a lot of credit customers paid their bills in that period, when actually sales have been slow. Because the accrual method shows the ebb and flow of business income and debts more accurately, it is generally recommended for all but the smallest businesses.

Whichever method you use, it's important to realize that either one gives you only a partial picture of the financial status of your business. To have a true understanding of your business's finances, you need more than just a collection of monthly totals; you need to understand what your numbers mean and how to use them to answer specific financial questions, as discussed in the rest of this chapter.

Step 1: Keeping and Organizing Receipts

Comprehensive summaries of your business's income and expenses are the heart of the accounting process. But unless you want to flirt with tax fraud, you can't just make up the information in your books. Each of your business's sales and expenditures must be backed up by some type of record containing the amount, the date, and other relevant information about that transaction. The best way to stay organized is to have a system in place—in other words, a set of files, folders, cash register receipts, or whatever else that you use consistently over time, so that you always know where to find the information you need.

From a legal point of view, your method of keeping receipts can range from slips kept in a cigar box to a sophisticated cash register–based system; this might include point-of-sale (POS) software, which typically goes beyond tracking transactions to managing categories and subcategories, inventory, and more. Practically, you'll want to choose a system that fits your business needs. For example, a small service business that handles only a few jobs might get by with a bare-bones approach. But the more sales and expenditures your business makes, the more sophisticated your system needs to be. Whether your needs are simple or complex, the important thing is to make sure that you and any staff know the system and use it consistently. If your records aren't accurate, the financial statements you make from them won't be, either.

This section discusses common ways of keeping your receipts. The bottom line is to choose or adapt one to suit your needs.

Income Receipts

Every time your business brings in money, you need a record of it. Most of your revenue will come from sales of your products or services, but keep in mind that some might come from loans or capital contributions. How you keep track of sales will vary a great deal, depending on what type of business you run and how many sales you make. Businesses such as grocery stores that make hundreds or even thousands of sales a day will likely need a cash register (and possibly an integrated POS system) to record each sale. Other businesses with slower sales, such as hair salons or auto shops, could manage by simply writing out a receipt for each sale from a receipt book. Freelancers and consultants generally use their invoices marked "Paid" as income receipts.

Regardless of how you generate income receipts, they should always include the

date, a brief description of the goods or services sold, an indication of how payment was made, whether the sale was subject to sales tax, and if so, the amount of sales tax separate from the total.

If any of your sales are subject to a state or local sales tax, it's critical that your income receipts distinguish a pretax total from the amount of sales tax charged. Your income records must reflect whether a sale is taxable and, if so, the amount of sales tax. If any of your sales are subject to local or state sales taxes, you'll need this information to compute and file your state sales tax returns. If you use a cash register, taxable sales will generally be marked as such by the push of a button at the time of each sale, and tax amounts will be shown separately.

If you write out a receipt of each sale by hand, be sure to show any sales tax separately, not just as part of a total. If the sale is nontaxable, make that clear by writing "no tax," "nontaxable," or the like.

Finally, document any income your business receives from sources other than sales and keep these receipts separate from your sales receipts. If you get a loan or contribute your own personal money to the business, record this with some sort of receipt or promissory note. Be sure your written records adequately describe the source of income so you'll know whether to count it as taxable income or not.

Most income generated from sales of your products or services, for example, will be taxed at the end of the year, while income that you personally contribute to the business will not.



TIP

While it's merely a good business practice to give receipts to customers who purchase goods or services, it's a legal requirement that you keep a copy for yourself. Therefore, if you write out your own receipts, you'll need to make two copies—one for you, and one for the customer. Cash registers and most receipt books make each record in duplicate.

Expenditure Receipts

Just as you keep a record of each individual sale, you need to keep a record each time you spend money for your business. Business expenditures include paychecks to employees; money spent on supplies, office rent, and telephone bills; payments on loans; and all other costs associated with your business. Legally and practically, each and every one of these expenses must be recorded.

The easiest way to ensure that you track every expense is to make sure to keep a written or digital receipt for every transaction in which you spend money for the business. Each expenditure receipt should include the date, the amount, the

method of payment, who was paid and—most important—a description of what type of expense it was, such as rent, supplies, or utilities. The description is important because later, when you enter your expenses into your bookkeeping software, you'll need to assign one or more categories to each expense. These categories—such as rent, advertising, supplies, utilities, meals, travel, and taxes—are important for tax purposes, because each type of expense has a particular rule for deductibility. If any important information isn't included on the receipt, write it in. Later, when entering receipts into your bookkeeping system, you'll be glad you made sure to note the important information.

Bear in mind that you'll sometimes get multiple copies of receipts (hard copy or digital) for a single purchase: a credit card receipt, a register receipt, and an itemized statement, for example. If you don't keep them organized, it can be confusing when entering into your bookkeeping system. Adopt an organizational system to keep them in order.

Step 2: Entering Receipts Into Bookkeeping Software

On a regular basis—every day, once a week, or once a month at a minimum—you should update your bookkeeping software with your income and expense transactions. (If you use a system like *QuickBooks* that's synced to your bank account, the transactions may automatically be entered; we'll point out a few things to watch out for later in this section.) Later, you'll use the data you've entered to answer financial questions about your business, such as whether you're making a profit and, if so, how much.

Generally speaking, the more sales you make, the more often you should enter your receipts. A busy retail operation that does dozens of sales every day or more should post daily, while smaller, slower businesses with just a few large transactions per month would probably be fine posting weekly or even monthly. With a high sales volume, it's particularly important to see what's happening every day and not to fall behind with the paperwork. For this reason, most busy, high-volume businesses will have a modern point-of-sale system that syncs all transactions with the bookkeeping software.

If you manually enter information into your bookkeeping software, remember the adage "garbage in, garbage out." If the information you enter isn't accurate or the software isn't set up correctly in the first place, you won't be able to generate the meaningful financial reports that are so crucial to any business. Take the time early on to learn how your software works, configure it correctly, and enter data carefully to minimize errors.

Let's take a look at some of the details involved in setting up your bookkeeping

software and entering transactions. Remember, once the transactions are entered, accounting software makes preparing monthly and yearly financial reports incredibly easy.



TIP

Learn the concepts behind the numbers. Even though bookkeeping software allows you to generate sophisticated financial reports with a few mouse clicks, you should still take the time to understand how the numbers fit together and what they mean. The more you know about your numbers and the relationships between various figures, the better able you'll be to make positive and profitable business decisions.



TIP

Create a "catch-all" account for business expenses paid for with personal accounts. Inevitably, business owners occasionally spend money from their personal accounts (using either cash or a debit or credit card) on business expenses. While you should strive to avoid this, it just happens from time to time—for example, you bought some business books among a bunch of personal books paid for with your personal debit card; or you bought a work uniform along with personal clothes and paid for it all with your personal checking account. One good way to account for these stragglers is to create a "general register" account in your bookkeeping software as a catch-all account that will include any transactions (usually expenditures, not income) that for whatever reason weren't made from an official business checking or credit account.

Creating Accounts

When setting up your bookkeeping software, one of the first things to do is set up accounts to mirror the business accounts you have in real life: a checking account and a credit card account, for instance. It's critical to post transactions to the appropriate accounts, so that you can reconcile your bookkeeping records against the bank or credit card statements. Reconciling each month is an important way to make sure your records are complete and accurate; we'll describe the reconciling process in a bit more detail below.

Depending on your circumstances and how your accountant or bookkeeper advises you, you can create other accounts to track your business's finances. Common examples include separate accounts for receivables (amounts owed to you) and payables (amounts you owe to others), or accounts to track depreciable assets, such as computers or vehicles.

Again, a bookkeeper can be quite useful in helping you figure out which accounts to set up.

Creating Income and Expense Categories

Besides creating accounts, an important reason for setting up your bookkeeping software is to create categories for income and expenses. Because some types of income and expenses are treated differently than others for tax purposes, it's essential to track them separately in your bookkeeping system. As we discussed in Chapter 9, some expenditures can be deducted right away in full, others may be deducted only over several years (referred to as "depreciating expenses"), while other costs might not be deductible at all.

Income categories will typically include "taxable sales," "sales tax," and "nontaxable sales" categories and possibly others—say, "travel reimbursement," "loan," or "interest income." Businesses typically have many categories for expenses such as rent, utilities, computer equipment, employee wages, legal fees, postage, or travel, to name a few.



RESOURCE

The IRS has oceans of rules. For more information on different types of business expenses and their deductibility, read *Deduct It! Lower Your Small Business Taxes*, by Stephen Fishman (Nolo). Reading the rules issued by the IRS isn't a bad idea, either. IRS Publication 334, *Tax Guide for Small Business*, is a good place to start. It's available at www.irs.gov.

Besides categorizing income and expenses to account for different tax treatment, there's another essential reason to categorize expenses: Careful, strategic categorization will allow you to generate financial reports that reveal which aspects of your business contribute the most (or least) to your bottom line, which in turn will allow you to make adjustments to maximize profits. We'll discuss the details of financial reports in the next section, but the point here is that categorization is essential. Without tracking income and expenses by category, you won't be able to generate meaningful financial reports later on.

EXAMPLE: Shane is launching a photography studio that will focus on weddings, baby portraits, and professional headshots. When setting up the bookkeeping system (with the help of a trusted bookkeeper), Shane makes sure to include separate categories for income from these three separate services. This way, he will be able to generate reports showing which services bring in the most gross income. In addition, Shane makes sure to categorize expenses so that he will be able to generate reports showing the expenses associated with each of the services, as well as reports comparing income to expenses for each service.

After six months in business, the financial reports show that the weddings consistently generate the most gross income. The profitability picture is different, however. When expenses

associated with each service are factored in, Shane sees that baby portraits are actually the most profitable service, because baby photos have much lower costs than the wedding shoots. Shane decides to put some effort into lowering the costs associated with weddings in order to make them more profitable. If Shane had not created separate income and expense categories for weddings, baby portraits, and professional headshots, the financial records would not have revealed the revenue and profit trends, and Shane would have missed out on the opportunity to tweak his marketing and pricing in order to boost profits.

When deciding which categories to create and track, keep in mind the distinction between fixed costs and variable costs. Variable costs, you may remember from Chapter 4, are tied to your products or services, while fixed costs (overhead) more or less stay the same regardless of your production and sales volume. Without keeping careful track of variable costs, you won't know how profitable your individual products or services are, or whether your pricing is too high, too low, or just right. Fixed costs are also crucial to track, in large part because they can be such a drain when business is slow.

There's something of an art to defining the categories that are relevant for your business. You want them to be tightly defined—but not so narrow that you end up with dozens of tiny groups. For example, a handyman might use categories such as lumber, paint/sealants, hardware, and equipment rentals, but wouldn't go so far as to have a separate category for nails versus screws. A hair stylist might use categories like booth rental, cutting tools, and hair products; depending on her circumstances, she might want to further subcategorize the hair products into shampoos, conditioners, and styling products. An experienced bookkeeper familiar with your field can be extremely helpful in setting up your categories and subcategories in a way that will help you generate the most meaningful reports for your business.

As for actually setting up the categories in your bookkeeping software, all programs make this really easy. Generally speaking, you'll create the categories when you set up the software; later, when you enter your transactions, you'll choose from the list of categories you've created. Undoubtedly, over time you'll refine your bookkeeping system and your categories, and all bookkeeping software allows you to add, edit, and delete your categories whenever you want.

Typical Expense Categories

As a general reference, here's a list of common expense categories:

- advertising
- automobile
- bank charges
- cleaning services
- copying
- delivery/freight/shipping
- dues and fees
- education (classes, workshops, and so on)
- employee wages
- equipment/furniture/computers
- equipment rental
- insurance
- interest on business debt
- legal and professional fees
- meals (business related)
- membership
- office expenses/supplies
- office rent
- online services
- postage
- publications (books, magazines, and so on)
- software
- tax preparation fees
- taxes
- telephone
- travel, and
- utilities (gas and electric).

Entering Transactions

When it comes time to enter the information from your receipts into your bookkeeping software, you'll enter the key information from each income or expense transaction including date, check number, payee, description, amount, category(ies), and any notes. If you use a system like *QuickBooks* that is synced with your bank account, this step will be done automatically.

Assigning the right category to each transaction is essential for your reports to be meaningful. Note that *QuickBooks* and other systems that are synced with your bank and automatically add transactions, the category they enter may be wrong. It's essential for you to review these transactions manually and correct any categories that have been misassigned.

With income transactions, remember to show any sales tax amounts separately from the total income. Bookkeeping software generally allows you to do this by "splitting" a transaction, showing a pretax subtotal separate from the sales tax amount.



TIP

Some states require nontaxable sales to be broken down into certain categories, such as wholesale sales, services, sales to out-of-state customers, or freight charges. Check with your state sales tax agency to find out which, if any, nontaxable subcategories you must use in your record keeping.

When you have entered a receipt, mark the receipt as entered. Use whatever system works for you; you could handwrite an "E" on the receipt, organize digital receipts into an "Entered" folder or something similar. However you store your receipts, use a system that will allow you easily to find a receipt should any questions arise later.

Finally, keep your digital bookkeeping records safe and regularly back them up. They will be essential to create financial reports revealing your business's financial health (explained in "Step 3: Generating Financial Reports," below), and to complete your local, state, and federal tax returns. Losing your financial records can be an expensive disaster—dealing with an IRS audit with- out them is just one nightmare scenario— so treat them as the important business documents that they are.



TIP

Treat credit card purchases like cash. Even though the cash method of accounting records expenditures when they are paid, not when incurred, you should record purchases made with a credit card as if they were paid with cash. For whatever reason, the IRS considers credit card purchases paid on the date of purchase, not when payment is made on the credit card.

Step 3: Generating Financial Reports

Financial reports pull together various financial data to answer specific questions about your business's financial situation. For example, a profit and loss report compares monthly income to monthly expenses to show whether your business is making enough sales of products or services to cover costs each month. A cash flow projection shows similar information, but includes other sources of income such as capital contributions from owners or loans (that is, not just revenues from sales), and organizes the information slightly differently to show you whether the timing of your income is adequate to pay your bills on time.

The financial reports discussed in this section are easily generated from your bookkeeping software—assuming that you've entered data consistently and correctly.

Profit and Loss Statement

If the typical owners of a small business start-up got a nickel for every time they asked themselves, "Will my business make a profit?" they'd probably be rich enough to retire before the doors were even open. A profit and loss statement (also called a P & L, or an income statement)

is designed to answer this very question. Chapter 4 discussed creating a profit and loss forecast with projected numbers. This section explains how to do a P & L after you've opened your doors and have actual numbers to work with.

A P & L shows you pretty much what the name implies: how much profit or loss your business is making in a given period of time. You'll typically generate a profit and loss statement each month, as well as quarterly and annual summaries. We'll use a monthly period when describing the process of creating a P & L, below.

In the most basic terms, a P & L is made by totaling your monthly revenues and then subtracting your monthly expenses from that total. If you use accounting software, it will generate a P & L at the click of a button based on the income and expense data you've already entered. For each month, you'll be able to see whether your revenues are higher or lower than your expenses and by how much. The monthly results are totaled to obtain your annual profit or loss. An important detail involved in profit/loss calculations is that fixed costs need to be considered separately from variable costs. Fixed costs (also called overhead) are the costs associated with running your business in general, not with individual products or services themselves. Examples include rent, utilities, and insurance. Variable costs (also sometimes called costs of goods sold, or COGS) are the expenses that are directly tied to the product or service that you're selling. Examples include the costs of materials, packaging, and labor costs directly tied to producing the product or service (but note that labor costs can be tricky; see "Labor costs: sometimes variable, sometimes fixed" below).

For example, say your business produces and sells greeting cards. Your variable costs would include the costs of the paper, printing costs, costs for packaging and labels, and the labor cost for the workers that package and distribute them. As the name implies, these costs will vary depending on the amount and type of product you make and sell or service you perform. For example, if you produce more or less of a particular greeting card or if you emboss or use a heavier grade of card stock, your variable expenses will be affected.



TIP

Labor costs: sometimes variable, sometimes fixed. If you ask a group of accountants whether the labor costs associated with making a product are fixed or variable, you're likely to get conflicting answers. Some argue that, as long as the workers will get paid regardless of whether they're working on that product, their salaries should be considered fixed, like rent or utilities. Others say that, to have accurate financial records, you need to reflect the cost of the labor that goes into a product. You or your accountant can decide how your business will categorize labor costs for making a product. Labor costs for providing services, on the other hand, are almost always treated as variable costs.

But other costs—your fixed costs—will not go up or down depending on the products you make or the services you perform. These costs, such as your rent, office utility bills, and insurance for your company vehicles, will be more or less the same, regardless of the amount or type of greeting cards you make. This is exactly why age-old business wisdom says to keep your overhead costs as low as you can. In times of slow sales, you want to be saddled with as few fixed costs as possible.

Now that you know the distinction between variable and fixed costs, you need to understand how they're each subtracted from your revenue on a typical profit and loss statement.

1. A profit and loss statement starts with your total sales revenues, then subtracts your variable costs. The result is called your *gross profit*—how much money you've earned from sales of your products or services over and above their cost to you.
2. Next you subtract your fixed costs from your gross profit. Any money you're left with is usually called *net profit*, but is sometimes called net income or pretax profit. Other than the various taxes you'll need to pay on this income, this is your (and any other business owners') money.

20xx Profit/Loss Statement

	Jan	Feb	Mar	April	May	Dec	Year Total
Sales Revenues	$1,900	$1,950	$2,000	$1,850	$2,000	$2,100	$23,550
Variable Costs	(300)	(310)	(350)	(300)	(325)	(350)	(3,840)
Gross Profit	1,600	1,640	1,650	1,550	1,675	1,750	19,710
Fixed Expenses							
Rent	(700)	(700)	(700)	(700)	(700)	(700)	(8,400)
Supplies	(150)	(100)	(75)	(90)	(125)	(100)	(1,220)
Utilities	(200)	(200)	(200)	(200)	(200)	(200)	(2,400)
Advertising	(150)	(150)	(150)	(150)	(150)	(150)	(1,800)
Misc.	(75)	(80)	(65)	(70)	(75)	(85)	(830)
Total Fixed Expenses	(1,275)	(1,230)	(1,190)	(1,210)	(1,250)	(1,235)	(14,650)
Net Income (Loss)	$325	$410	$460	$340	$425	$515	$5,060

To sum up, the formula used in a profit and loss statement is basically as follows:

	Sales revenue
–	Variable costs (costs of sale)
=	Gross profit (gross margin)
–	Fixed costs
=	Net profit

A typical P & L is shown above.

A P & L not only will tell you whether you're making or losing money, but also will help you identify which aspects of your business need adjusting in order to boost profits. Often, a profitability problem can be found in your expenses. Being able to see the totals of each of your various expense categories over the course of several months, all on one report, can help you pinpoint areas in which you're spending too much money (and help give you the courage to do something about it). And, of course, accurately tracking income totals month by month will help you quickly spot a downturn in revenue and prompt you to take action to boost sales.

Cash Flow Projection

Chapter 4 discussed cash flow projections as a way to determine whether your business will be able to pay its bills once it gets started. A cash flow projection is also a crucial tool to use in your ongoing business, as it tells you whether you'll have enough cash available at any given time to pay your operating costs. Having lots of customers and thriving sales isn't enough, especially if you sell on credit.

If your customers pay you in 90 days, but you must pay your expenses in 30 days or even immediately, you could face a situation where, even though your financial statement says you are making a profit, you can't pay your staff, rent, utilities, insurance, delivery services, or other key bills. If you see the cash crunch well in advance, you'll usually be able to juggle expenses or take other measures, such as taking out a loan or a line of credit to get through the squeeze. But if the cash crisis sneaks up on you without warning, you might not have enough time to react, possibly even forcing you to close up shop.

Helping you understand why you might not be able to pay your bills despite being profitable—and how to take steps to avoid this—is the role of a cash flow projection. A cash flow projection focuses on the actual cash payments made to and by your business. These payments are called cash-ins and cash-outs (or inflows and outflows) to differentiate them from sales and expenses, which might not be paid right away. Estimating your cash-ins and cash-outs for upcoming months can help you predict when you might run short, allowing you to take action early, such as by tightening up on your credit terms,

raising more capital, getting a loan or line of credit, or putting more effort into collecting accounts receivable.

Your cash flow projection will use most of the same numbers as your profit and loss statement, along with a few new ones. The big difference is that your cash flow projection will include all of your sources of income—not just sales income—and only income that's paid in cash (not credit). In other words, while your profit and loss statement is concerned with how much revenue your business is earning through sales of its products or services, your cash flow projection is designed to show you how much cash you will have on hand from all sources, including paid sales, loans, interest from investments, transfers from your personal accounts, lottery winnings, whatever. That's because when it comes to paying bills, the bottom line is whether you have enough money, period. Similarly, your cash flow projection will include all money you pay out of the business, whether for supplies, taxes (including any estimated taxes you owe; see Chapter 9), loan repayments, or any other expenditure.

The basic formula for cash flow analysis is:

	Cash in bank at beginning of month
+	Cash receipts for the month
–	Cash disbursements for the month
=	Cash in bank at end of month

In a cash flow projection, each month starts with the amount of money you have in the bank. (This number will generally be the same amount that's left over from the previous month.) Next, you'll add any cash that came in during the month in all relevant categories, such as sales income, loans, interest earned, and any personal money you put into the business—your total cash-ins for the month. Next, subtract the money you spent during the month: your cash-outs. The result is the cash left at the end of the month. Enter that figure into the beginning of the next month's column, and do the same process for the next month. If you use accounting software, it can generate a cash flow spreadsheet automatically once you've entered figures for income and expenses.

Now that you see the basic formula behind cash flow analysis, you need to understand that the real power of this tool is not in tracking actual cash-ins and cash-outs, but in predicting future cash flows. Periodically, say once a month or every couple of months, you should use your actual figures to help make estimates for upcoming months and complete a cash flow projection for the future, generally up to one year. Hopefully, you'll see that you will have enough cash to cover your expenses each month. If not, don't panic. First, pat yourself on the back for doing a cash flow analysis and figuring out ahead of time that you won't be able to

Cash Flow Projection, Completed April, 20xx

	January	February	March	April	May
Cash at Beginning of Month	$2,000	$1,250	$600	$700	$350
Cash-Ins Sales Paid	15,000	14,750	15,500	14,750	15,500
Loans and Transfers	0	0	0	0	0
Total Cash-Ins	15,000	14,750	15,500	14,750	15,500
Cash-Outs **Variable Costs**	3,000	3,100	3,500	3,000	3,250
Rent	7,000	7,000	7,000	7,000	7,000
Supplies	1,500	1,000	750	900	1,250
Utilities	2,000	2,000	2,000	2,000	2,000
Loan Payments	1,500	1,500	1,500	1,500	1,500
Misc.	750	800	650	700	750
Total Cash-Outs	15,750	15,400	15,400	15,100	15,750
Cash at End of Month	$1,250	$600	$700	$350	$100

cover all your expenses. Then come up with a plan—either put off some expenses that can wait; get more money (perhaps through collecting accounts receivable or getting a short-term loan or line of credit); or sell, sell, sell more products or services.

Especially when you're in the early stages of a business and don't have much of a business history, predicting cash-ins and cash-outs for future months isn't easy (though cash-outs are often easier to predict than cash-ins, because you have more control over them and many costs recur each month). You'll need to make estimates of how much income will come in and what expenses must be covered—a task that may seem only slightly easier than reading tea leaves.

The key is to do your best—with an emphasis on "do." Accept the fact that your estimates won't be 100% accurate, but make them anyway. As the months tick by and the flow of cash into and out from

Cash Flow Projection, Completed April, 20xx (continued)

June	July	August	September	October	November	December
$100	($300)	$150	$0	$0	($550)	$300
15,000	16,100	16,250	15,500	15,250	16,750	16,900
0	0	0	0	0	0	0
15,000	16,100	16,250	15,500	15,250	16,750	16,900
3,150	3,450	3,500	3,250	3,300	3,400	3,550
7,000	7,000	7,000	7,000	7,000	7,000	7,000
900	1,100	850	1,000	1,100	950	900
2,000	2,000	2,000	2,000	2,000	2,000	2,000
1,500	1,500	1,500	1,500	1,500	1,500	1,500
850	600	1,550	750	900	1,050	850
15,400	15,650	16,400	15,500	15,800	15,900	15,800
($300)	$150	$0	$0	($550)	$300	$1,400

your business settles into daily, weekly, and monthly patterns, making estimates will inevitably become easier, and you'll find them increasingly more accurate.

An example of a cash flow projection you can do on a simple spreadsheet is shown above.

As you can see, arranging income and expense information into a cash flow projection reveals a lot about the financial workings of a business. For example, the sample cash flow forecast shows that cash is tight each and every month (look at the "Cash at End of Month" row), so the business owner might consider ways to cut costs or to tighten credit terms.



TIP

Compare your projection to reality. Each month, replace your projections with actual results from your accounting system. It's a great way to see how good a job of projecting you're doing.

Of more pressing importance is the projected cash shortfall starting in June. Knowing a few months in advance that a shortage is likely will help a business owner figure out what to do while there's still time to take action. The owner could contribute some personal money to the business (note that the cash flow didn't include any loans or personal transfers to the business) or could try to cut some nonessential expenses, at least until later in the year when there will be a bit (but only a small bit) more cash available.

Balance Sheet

A balance sheet is a financial report showing the net worth of your business at a particular point in time. Businesses typically generate balance sheets monthly, quarterly, and annually. In a nutshell, a balance sheet shows a complete picture of a business's financial situation by summarizing its assets, liabilities, and owner equity (sometimes called net worth) in the business. The general formula is:

Assets – Liabilities = Equity

Or, put another way:

Assets = Liabilities + Equity

As you'll see in the following example, the structure of a balance sheet reflects this second formulation. But each of them means the same thing, as described below.

The value of a balance sheet is that it provides a view into the business's financial position. It will reveal whether a business is, on one hand, overleveraged with too much debt or perhaps, on the other hand, in a good position for expansion. In short, it offers a snapshot of the financial health of a company, reflecting the balance between assets, on one side of the equation, and liabilities plus equity, on the other side. When the data in your bookkeeping software are accurate, the assets will equal (or "balance") liabilities plus equity.

While balance sheets aren't quite as intuitive to read for the uninitiated, the elements that are included and how they relate to each other aren't that complicated. As with the other financial reports described in this section, a balance sheet can easily be generated from your bookkeeping software, assuming all transactions have been entered and categorized correctly. But it's worth going through each element of a balance sheet so that you truly understand what it means and how to decipher one, rather than just relying on your software to spit one out for you without grasping the full meaning of the information it summarizes.

Let's look at each element in the balance sheet in more detail.

Assets include anything of monetary value that your business owns. The standard balance sheet format lists assets in decreasing order of liquidity—in other words, how easy it is to convert the asset to cash. The following categories are typically used to reflect this breakdown:

- **Current assets** are those that can be converted to cash within one year. These include cash (of course), checking accounts, money market accounts, accounts receivable, and inventory.
- **Noncurrent assets** (sometimes called capital, long-term, or fixed assets) are defined as things with a useful business life of more than one year. These include land, buildings, vehicles, business equipment, and furniture. With the exception of land, tangible noncurrent assets depreciate, which means they lose value each year; this is reflected as a "depreciation expense" in the balance sheet. If all assets are entered correctly into your bookkeeping software, including the type of asset and when it was purchased, the software should automatically calculate this overall depreciation figure for you. Other assets that would be considered noncurrent include intellectual property, such as patents, trade secrets, copyrights, trademarks, customer lists or even company goodwill. Valuing these intangibles can be difficult, and they are typically heavily discounted on a balance sheet if included at all.

Liabilities are things that your business owes to others. Like assets, liabilities are typically divided into current and noncurrent:

- **Current liabilities** include debts your company owes within the next year. Examples include accounts payable, payroll owed to employees but not yet paid, accrued but unpaid taxes, loans that need to be repaid within the year, and credit card debt.
- **Noncurrent liabilities** include debts payable over a term longer than one year. This includes mortgages or other debts due more than one year from the date the balance sheet is prepared.

Equity is what's left over when you subtract liabilities from assets. This is the net worth of the business, which is essentially the amount that would be paid out to the owner(s) if the business liquidated. It includes:

- Any **capital contributions** to business, including money contributed by the owners and any stock sold to the public.
- Any **retained earnings**, which are the total of all annual profits since the beginning of the business (including the current year) that haven't been paid out to the owner(s) in draws or dividends.

Balance Sheet

	Current 4/1/20xx	Previous Year 4/1/20xx	$ Change	% Change
Assets				
Current Assets				
Cash in bank	$15,700	$14,050	$1,650	11.74%
Accounts receivable	2,350	1,800	550	30.56%
Inventory	5,500	3,900	1,600	41.03%
Other current assets	0	0	0	0.00%
Total Current Assets	$23,550	$19,750	$3,800	19.24%
Fixed Assets				
Machinery & equipment	$13,500	$11,075	$2,425	21.90%
Furniture & fixtures	2,500	2,000	500	25.00%
Land & buildings	0	0	0	0.00%
Other fixed assets	0	0	0	0.00%
(Accumulated depreciation on all fixed assets)	(7,350)	(7,155)	(195)	2.73%
Total Fixed Assets (net of depreciation)	$8,650	$5,920	$2,730	46.11%
Other Assets				
Intangibles	$0	$0	$0	0.00%
Goodwill	$0	$0	$0	0.00%
Other	$0	$0	$0	0.00%
Total Other Assets	$0	$0	$0	0.00%
Total Assets	$32,200	$25,670	$6,530	25.44%
Liabilities and Equity				
Current Liabilities				
Accounts payable	$4,250	$2,985	$1,265	42.38%
Payroll unpaid	$0	$0	$0	0.00%
Taxes payable	1,700	985	715	72.59%
Short-term debt (due within 12 months)	$0	$0	$0	0.00%
Credit card debt	$0	$0	$0	0.00%
Other current liabilities	$0	$0	$0	0.00%
Total Current Liabilities	$5,950	$3,970	$1,980	49.87%

Balance Sheet (continued)

	Current 4/1/20xx	Previous Year 4/1/20xx	$ Change	% Change
Long-Term Debt				
Bank loans payable	$0	$0	$0	0.00%
Other long-term debt	$0	$0	$0	0.00%
Total Long-Term Debt	$0	$0	$0	0.00%
Total Liabilities	$5,950	$3,970	$1,980	49.87%
Owners' Equity				
Invested capital	$15,000	$15,000	$0	0.00%
Retained earnings	11,250	6,700	4,550	67.91%
Total Owners' Equity	$26,250	$21,700	$4,550	20.97%
Total Liabilities & Equity	$32,200	$25,670	$6,530	25.44%

Above is an example of how a balance sheet typically presents this information.



WORKSHEET

Balance Sheet. The Nolo website includes a downloadable, fillable balance sheet that automatically calculates year-over-year changes. See the Appendix for the link to this worksheet and other forms in this book.

Accounting Software and Other Technology to Manage Your Business

In addition to bookkeeping software, other software and hardware products help business owners manage the money and operations of a business. These include spreadsheets, point-of-sale (POS) systems, project management software, appointment scheduling software, and customer relationship management (CRM) software.

Bear in mind that many business management applications are essentially databases that have already been customized for a specific purpose. They may be called "off-the-shelf" solutions, to differentiate them from more general database applications that need to be customized for your needs. For example, you could purchase a database program, such as *FileMaker Pro* or Microsoft *Access*, and customize it (likely with the help of a database specialist) to manage your consulting projects, including tracking hours, recording expenses, and generating client invoices. Or, you could purchase an off-the-shelf project management application such as *Trello* or *Asana* that has these functions preprogrammed.

The lines between different types of business management software are becoming blurry. The features, functions, and add-on capabilities of business management applications change frequently as software companies try to offer more and "be everything" to attract more customers. For example, project management applications change frequently as software companies try to offer more and "be everything" to attract more customers. For example, project management applications might add CRM features or introduce companion CRM software; likewise, CRM software might add project management tasks to its feature set. Tons of business apps integrate with *QuickBooks*, allowing you to streamline project management, CRM, inventory, and more with your bookkeeping system. Note, however, that fully integrating your systems can be complicated and require hiring help, which can get expensive.

Let's take a closer look at bookkeeping software; then we'll review the other applications and databases that you might consider using to manage your business.

Bookkeeping Software

QuickBooks is by far the most popular bookkeeping software; it offers products for different sizes and types of businesses, including an online version that stores all your information on its servers. Another option for businesses at the small end of the spectrum is *Quicken*, which focuses more on personal finances but offers a *Home & Business* version with plenty of features for small operators.

When choosing bookkeeping software, pick a product that offers the features you need, keeping in mind the information you need to track and what reports you need to generate. For instance, if you need to manage multiple categories of inventory and must regularly deal with returns from retailers, the software and the version you choose should make it easy to enter and categorize inventory and to generate reports, such as a yearly summary of returns by category or by a particular retailer *QuickBooks* offers dozens of add-on products, including many industry-specific

applications to help you manage certain kinds of businesses, such as restaurants, retail, or manufacturing.

The Move from Software to Platforms

A decade or so ago, using technology usually meant purchasing software and installing it on your computer. It's different these days; most apps are "in the cloud"; you create an account and log in via a browser. Cloud-hosted apps—often called "platforms"—remove the headache of buying and installing updates every few years.

Another big plus is that you can access your data anywhere you have internet access.

And, remote teams can easily collaborate which each other, even if they're on opposite sides of the globe. If you've ever dealt with the headaches of emailing files among multiple team members, you'll appreciate the value of real-time editing of documents in the cloud. Many platforms are geared for mobile devices, allowing your team to keep projects moving even if they're on the go.

While business platforms offer huge productivity boosts for small businesses, don't underestimate the time and savvy required to choose, install, and maintain your set of tools. (Tech folks call this collection your "stack.") And even the best-managed systems will go down occasionally, usually at a terribly inconvenient time. Make sure someone on your team has the time and experience to do the technology-taming that is a reality for most ventures, even small ones.

Finally, make sure your bookkeeper and accountant can work with whatever software you choose. Virtually all financial management professionals work with the various *QuickBooks* products.

Spreadsheet Software

A spreadsheet is a document that allows you to store information in rows and columns, making it easy to sort the information in different ways. For example, a spreadsheet containing information about your clients could have column headers of "First Name," "Last Name," "Business Name," "Business Address," "Business Phone Number," and so on, with each row containing that information about one of your clients. If you had 50 clients, you'd have 50 rows of data, and you'd be able to sort the list by first name, last name, business name, or any other column.

Beyond sorting, the real power of spreadsheets is in their ability to do mathematical formulas. This makes them particularly useful for doing budgets, project estimates, and projections, in which you'd use estimates instead of actual financial data. (To track actual data you'll be better off using bookkeeping software, as described above.)

For example, you could use a spreadsheet to cost out a landscaping project, entering individual expenses in separate lines: "Dirt," "Gravel," Weed Barrier," "Plants," and so on. You could define one

cell to display the sum total of all the individual expenses, so when you tweak individual line items the total will be automatically updated. Using a spreadsheet in this way makes the budgeting process much easier and faster than if you had to manually add together the expenses each time you made a change.

In essence, a spreadsheet is a mini-database, which is software for managing lots of pieces of information. (Databases are discussed separately below.) Like databases, spreadsheets allow you to do mathematical formulas and functions, as well as sorting and filtering of text data.

To do sophisticated or complex formulas, sorting, or filtering, you'll probably want to go with a true database that will typically have more robust reporting functions already built in and require much less customization. For example, you could easily customize a client and project database to create a report showing what clients were signed in a specific year, with a list of projects you completed for each of those clients, sorted by the total amount of project fees. You could track similar information with a spreadsheet and create a similar report, but it would typically take considerably more work to do so. In addition, if you have a lot of data, using a database is preferable to scrolling through hundreds of lines of a spreadsheet.

If you don't use databases for whatever reason—perhaps your business needs are simple, or you can't afford to buy and customize a database at the moment—spreadsheets are a great alternative. They're cheap, easy to use, and quite powerful for a wide variety of applications. Besides budgeting and job-costing, they can be great for tracking project hours or maintaining client or vendor lists.

The most common spreadsheet software is Microsoft *Excel*, which you might already own as part of a Microsoft *Office* package. Another very practical option these days is to use Google *Sheets*, which are web-based and allow multiple users. For example, a small sales team could use a Google spreadsheet to manage its list of prospects. Whenever a salesperson contacted a prospect, they could enter the encounter information into the Google spreadsheet, which would automatically be visible to all other members of the team (who could also edit the spreadsheet).

Point-of-Sale (POS) Systems

Generally speaking, a point-of-sale (POS) system is a system for tracking and managing retail sales and inventory. While a handwritten receipt book could in theory be called a POS system, what is usually meant by this term is a computerized cash register system that handles each sales transaction as it is made; calculates the sales total and any sales tax; tracks inventory by SKU (stock-keeping unit)

Integrating Applications and Databases With Bookkeeping Software

If a feature isn't built into your bookkeeping software, and there's no add-on product that achieves what you need, it's possible that your business will need an external application or database to manage that information. For example, if you need to carefully track the hours and expenses of your consulting projects, you might want to use project management software (discussed below) in addition to your bookkeeping software. I discuss different types of management applications below.

With many types of business applications and databases, it makes sense to integrate them with your bookkeeping software so that the programs can share information, so that you don't have to enter information into both systems. For example, if your project management software is integrated with your bookkeeping software, when you create a client invoice within the project management software and mark it "paid," it will automatically enter a payment into your bookkeeping system.

Sharing information saves time and avoids the potential for errors and inconsistencies that arises when entering the same data into two different systems.

When considering whether you need to integrate various databases with your bookkeeping system, you'll simply need to weigh the improved and streamlined operations that integration offers, versus the cost. Integrating applications and databases with bookkeeping software typically requires the help of an experienced consultant and might be relatively expensive, often in the thousands or tens of thousands of dollars. For larger or growing businesses, the benefits of streamlining your operations may be well worth this expense.

If you want to integrate multiple applications, you'll need to make sure they're all technically compatible. The vast majority of external applications and databases have *QuickBooks* compatibility.

and automatically updates inventory databases; and generates detailed sales and inventory reports.

POS systems vary widely in the hardware and software they use; hardware often includes a computer and terminal or an electronic cash register, a bar code scanner, and a credit card swiping machine. The software varies in the complexity of the information it can track and report. You'll typically integrate the POS software with your bookkeeping software so that sales are automatically recorded into your books.

While *QuickBooks* and other bookkeeping software offer some inventory management functions, POS systems generally allow for more advanced management and reporting. More complex POS systems can manage inventory across multiple stores. Many POS systems are tailored for specific industries such as hair salons, medical offices, grocery stores, or restaurants.

To find the right POS system for your operation, start with some online research. You'll find many discussions among business owners who are sharing their good and bad experiences with various POS systems.



TIP

Don't be shy about asking other businesses what technologies they use. While you might find it difficult or awkward to approach other businesses that may be your competitors, you'd be surprised how easy it is to stop into a store similar to yours and strike up a conversation with the clerk or business owner (whoever is there) about your similar businesses. A direct question, "What kind of POS system do you guys use?" is likely to get a direct response, and possibly a conversation about their experiences. This information can be incredibly valuable. Of course this approach may not be advisable if competition is fierce between you and another business. Use your judgment.

Project Management Platforms

Service firms, consultants, and freelancers can often benefit from using project management software. Platforms such as *Notion*, *Asana*, *Trello*, and *Slack* help with a variety of details involved in managing projects; depending on the platform, management can include coordinating project team members, sharing files, sharing calendars and schedules, tracking billable hours, managing different billable rates, tracking project expenses, and invoicing clients. Freelancers often find the time-tracking and invoicing features particularly useful in automatically preparing professional-looking invoices, based on hours and billable rates entered into the system.

Each project management application will have a particular focus or strength in certain features and be less strong in others. Choose an application that handles the aspects of projects that will be important to you. Find out from other business owners (either directly or by reading comments online) what they like and don't like about the software. Features include:

- scheduling, including shared calendars
- budgeting and estimating projects and components
- time tracking
- billing and invoicing
- establishing different rates for different types of work
- file sharing and document distribution, and
- threaded messaging and chat.

Project management software can be integrated with your bookkeeping software if the two applications are compatible. If you plan to integrate these applications, confirm compatibility before purchasing.

Most project management software is pretty affordable. How you pay will depend on whether you purchase and install software, or use an online version. Overall, yearly costs start at around $100 for small businesses with just one user. Larger businesses and multiple users might end up paying a few thousand dollars a year.

Appointment Scheduling Software

Scheduling is a huge time sink for many of us, and it only becomes more of a burden the busier you get with a small business. If earning income from client meetings is a part of your business model, emailing back and forth with potential clients to find a time that works can be a huge drain on your productivity. Similarly, scheduling meetings with partners, collaborators or other business associates can eat up a lot of time and emails.

Enter appointment scheduling software. Apps like *Acuity Scheduling*, *Calendly*, or *TimeTrade* allow those who want to meet with you to book with you—and pay, if applicable—online. You set available times in the system, and the calendar will be accessible online to people you choose; typically you can provide your contacts a scheduling link, or embed your calendar at a "Scheduling" page at your website. When appointments are booked you'll get an email notification. Brilliant!

Consultants, lawyers, massage therapists, salon stylists, and anyone else who relies on client bookings should consider using one of these online appointment scheduling apps. Rates range from $10 a month to $50 per month or more for multiple users, and will be well worth the operational efficiency if you book only a few clients per month.

Customer Relationship Management (CRM) Software

Customer relationship management, or CRM, software helps a business manage potential and existing customers with the general goals of finding and retaining customers and reducing marketing costs. It started out as a tool to help salespeople—often a sales department—manage prospects, accounts, and territories, including tracking the types of outreach and communications that had been made to individual contacts. Today, CRM has grown into a more comprehensive strategy for managing customer service and marketing efforts.

CRM software is essentially a database that contains key information about current and prospective customers. From a sales point of view, the CRM application should identify the best prospects and provide key information about their needs in order to help the sales team turn them into paying customers. The CRM

database can also support customer service operations by including all information that may help a representative effectively assist the customer, such as what products or services were purchased, details of previous service calls, warranty expiration dates, and login information for the customer's online accounts.

Data in a CRM system can also be helpful to marketing departments in identifying trends and evaluating the popularity of the company's products and services. This in turn helps the marketing team develop marketing campaigns and messages.

As with other types of business management software, CRM software can be integrated with your bookkeeping application, depending on compatibility. If integration will be important for your business, make sure your choices are compatible before purchasing.

A popular CRM application for larger businesses is *Salesforce*, which can be integrated with *QuickBooks*. Other reputable products include *Keap* and *HubSpot*. For smaller operations, *ActiveCampaign* and *ConvertKit* are well regarded. Most of these applications have different versions, with a wide variation in cost.

Very generally speaking, a basic version for a small or one-person company might cost a few hundred dollars per year; a large company might spend tens of thousands of dollars a year for robust data functions and multiple users.

Customized Databases

The software discussed above consists of databases: software that helps you manage information. You can use databases to manage all kinds of information, such as clients, vendors, products, parts, employees, and more. Bookkeeping software is really nothing more than a database that has been customized to handle financial information; CRM software is essentially a database that's tailored for customer data.

When your business has complex tracking or reporting needs that can't be handled by an off-the-shelf solution, you might need to create a customized database from the ground up. With database software like *FileMaker Pro* or Microsoft *Access*, you can customize a management solution to handle your data and generate reports to suit your unique business needs.

Of course, customization from scratch comes with costs. While purchasing database software isn't terribly expensive in itself, hiring a consultant to customize it for you can easily run into the tens of thousands of dollars. You'll also need to maintain the database, such as making changes as needed and dealing with bugs and problems, so you'll need a maintenance budget of probably at least a couple thousand dollars a year, maybe considerably more. Make sure there's not an off-the-shelf product that could meet your needs—likely at a significantly lower

cost—before committing to the expense of a customized database.



TIP

Ask your bookkeeper and other business owners what software they recommend. Talk to people within your network who might know of industry-specific applications with features customized for your type of business. A bookkeeper can also help you set up the software and show you how to use it. You can usually test-drive these applications at their websites or with a trial version of the software. If an industry-specific application for your type of business is not available, *QuickBooks* offers several different versions to meet the needs of all sizes and types of businesses.

AI Tools for Small Businesses

As this edition is being written, the world of AI is exploding in scope and attention. AI broke through to mainstream use in 2023 with the release of "large language" AI tools like ChatGPT and Bard (known as chatbots). These tools generate text and images based on questions and commands (prompts) from users. Apps allow users to pose questions and have dynamic conversations with the app, which will answer questions in detail using internet-wide source material. For instance, when we typed "What is the difference between an LLC and an S corporation? Under 50 words" into ChatGPT, we received the following response:

"An LLC offers flexible ownership and taxation, while an S Corporation has stricter ownership rules and may face double taxation. Both provide limited liability protection to owners."

Not bad, right?

Around the same time that ChatGPT was released, AI image generators became widely available, enabling users to enter a description such as "dog eating an ice cream cone" and within seconds, a spookily accurate illustration is generated. Judge for yourself; this image was generated by *Canva* (an online graphics design tool used by many small businesses):



While text and image generators have dominated mainstream use of AI, a dizzying number of other AI-powered apps are hitting the market, including many aimed at small businesses. Because they are all so new, it is too early to tell which ones will endure and what overall impact AI will have in the world of business. But by all accounts, AI is poised to be a game-changer.

In this very early stage of AI adoption, let's take a look at some basics. There will undoubtedly be plenty to update in the next edition of this book.

- **Apps you already use are incorporating AI.** Related to the above, a trend to note is that many platforms are bringing AI into their operations. As noted in Chapter 1, online business plan generators like *LivePlan* and *BizPlan* have incorporated AI into their tools. As shown above, *Canva* offers an image generator. *Notion* (project management software) allows users to add AI properties to pages that will do things such as automatically summarize notes or translate content. You might find that such task-related tools—with AI under the hood—are more productive for you than using ChatGPT or Bard or Midjourney (for image generation) directly.
- **AI language models are powerful research and content generation tools.** Entering queries into ChatGPT can be mind-blowingly informative and can yield content useful for marketing, blogging, and more. But…
- **Reviewing AI results is essential. The results of a chatbot simply may not be accurate.** You should use your judgement and similar practices to when you use Google. Just as you shouldn't believe everything you read on the internet, you should verify the accuracy of a ChatGPT response.
- **Be especially careful attempting to use ChatGPT for legal tasks like drafting contracts.** As we noted in Chapter 11, we're not ready to recommend using AI for legal research or contract drafting. But you should keep an eye on AI-driven legal tools for small businesses as they evolve. Don't be afraid to try such tools if you think they might be helpful, but verify the accuracy of the results they produce.
- **AI raises ethical issues, to put it mildly.** The concerns about AI range from putting writers out of work, to copyright infringement of the content AI companies use to train their models, to potentially ending life on earth. Whether AI will turn

against humans is beyond the scope of this book, but it's fair to say that the impacts of AI on the workforce are real. Every business owner will need to examine their own values and ethics regarding using this technology. Will you replace staff with AI tools? Will you continue to hire local photographers, or will you instead use AI generated images? Will you use AI to generate marketing content, such as blog posts for your company's website? There are no right or wrong answers here, and the world will be figuring it out for some time to come.

We recommend trying out AI tools to see how they might help streamline your operation, while staying attuned to the pitfalls of accuracy and ethics.

Chapter 12 Checklist: Accounting and Technology

- ☐ Decide whether to use the cash or accrual system of accounting.
- ☐ Keep records of all payments to and from your business. Create an organized system for keeping your receipts.
- ☐ Enter your income and expense information into bookkeeping software on a regular basis. Businesses with high volumes of sales or expenses should do this frequently—daily or weekly. If appropriate for your business, hire a part- or full-time bookkeeper to keep up with this task.
- ☐ On some regular basis—typically monthly, quarterly, and annually—generate financial reports such as a profit/loss statement and a cash flow analysis to show you the big picture of how your business is doing financially.
- ☐ Consult with an accountant or tax professional at least once a year to keep your system on track.

CHAPTER

13

Small Business Marketing 101

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The process of reaching out to potential customers and trying to attract them to your business—broadly known as marketing—does not have to be terribly time-consuming, complicated, or expensive. In fact, some of the best marketing methods are the simplest and cheapest.

For example, encouraging good word of mouth and networking within a well-defined target audience will cost you little (if anything) and will greatly help your business develop name recognition and build a potential customer base. Other inexpensive marketing methods, such as being active on social media, cultivating relationships with journalists, and hosting events that are likely to get media exposure, can generate far better exposure than spending a fortune on advertising.

Before we dive into the nuts and bolts of marketing, keep in mind an important and often misunderstood distinction: Marketing is not synonymous with advertising. Paid advertising can be part of a marketing strategy, but it seldom makes sense for a small business to invest precious resources in ads. Paid advertising is much more expensive—and less effective—than many cheaper (or even free) methods of getting exposure, such as:

- networking with potential customers, other business owners, government officials, and community leaders
- creating incentives for your customers to pass good word of mouth about your business to others
- pitching stories about your business to local media
- organizing or participating in special events, such as a grand opening party, product demonstration, trade show, or informational seminar
- creating a website and promoting it
- engaging with current and potential customers on social media
- publishing a blog, podcast, or other business-related content
- distributing brochures, flyers, or other literature, and
- listing your business in local directories.

This chapter outlines a simple, affordable, and effective approach to marketing your business. Chapter 14 dives deeper into digital strategy and marketing online.



TIP

Valuable marketing lessons are all around you. We live in a world saturated with marketing appeals. As annoying as it is to be relentlessly courted by thousands of companies each day, constant exposure to marketing messages does have a bright side: Whether you've "studied" marketing or not, you've unwittingly absorbed some basic marketing know-how. As an experienced marketing target, you probably know more about marketing than you think you do. Use this knowledge to turn the tables—to think like a marketer, rather than a "marketee."

Defining Your Market

Your first concern when marketing your business is to understand who and what your market is. In fact, defining and learning about your market are fundamental steps in planning your business, period. You've probably heard this advice before, but what exactly does it mean to "know your market"? It's helpful to break the concept of "market" down into three components:

- your potential and actual customers
- your competition, and
- your industry.

Often, the term "market" is used as shorthand for your customer base. But it's crucial to understand that knowing your market also means knowing who your competition is, and what the trends are in your industry. When you have a clear vision and understanding of all three—customers, competition, and industry—you'll be well positioned not only to tailor your business to a profitable customer base, but also to reach that customer base with effective marketing strategies.

Let's look at each of the components of your market in a bit more detail.

Who Are Your Target Customers?

Every business needs to have a clear idea of who its most promising and likely customers are. Without having a vision of your expected customer base, you will seriously diminish your business's chances of success for a number of reasons:

- You may fail to realize there are not enough potential customers for your business (in other words, there is not enough demand for your products or services).
- You may miss opportunities to tweak your business idea to better meet the needs of a potential customer base.
- You won't know how to reach your most promising prospects, which is another way of saying you won't know where to target your marketing efforts.
- You won't be able to craft your marketing messages appropriately—using the right tone, language, and attitude to appeal to your best prospects.

In a nutshell, defining your target customers means identifying specific characteristics of the people or businesses who you believe are most likely to actually buy your product or service. These characteristics are sometimes called a demographic profile. Common characteristics used to classify customers include:

- age
- gender
- income level
- buying habits
- occupation or industry
- marital status

Common Marketing Terms

So many terms are thrown around when people are referring to marketing efforts—it can be hard to understand the distinctions among specific types of marketing, such as publicity, public relations, and media relations. Truth be told, there's often only a fuzzy line between these categories. Here's a quick definition of some of the most common marketing terms as they are used in this chapter.

Marketing means just about any promotional activity: advertising, special events, direct mail, online discounts and promotions, and the like. Marketing includes all ways of promoting your business.

Branding refers to the process of developing positive and specific associations in your target customers' minds regarding your business, above and beyond the basics of what products or services you provide. When a company has a well-developed brand, customers have an emotional tie to the company and a feeling of connection to the brand. For example, McDonald's is typically understood to be family friendly, cheerful, and fun. Volvo conveys the feeling of safety and quality. Levi Strauss & Co. projects a hip-yet-timeless vibe.

Advertising means buying print or digital space or airtime to deliver a promotional message designed to reach the general public, through print media, television, radio, the internet—or even the sides of buses and park benches.

Listings or directories include business directories and other specialized publications, both in print and online. Some, such as a directory of film production companies in a city, are highly targeted; others are very broad. As with advertising, you must pay for a listing. But, unlike most ads, directories often serve as valuable resources that are used again and again, which means they can be much more effective than typical display ads.

Public relations is another broad term that can refer to many different types of outreach efforts. In this chapter, public relations means a coordinated, multifaceted effort, often called a "campaign," to get your business's message out to the public. A public relations campaign might include sponsoring events, pitching stories to the media, inviting key people to participate in conferences, public speaking, and advertising—all coordinated to ensure clarity and consistency of message.

Media relations refers to contacting the media and pitching story ideas in hopes of obtaining editorial coverage—coverage in articles or feature stories not tied to advertising. Most commonly, media relations involves sending press releases to newspaper editors, reporters, and television producers to announce an event or provide information that could be the subject of a news story. Another media relations technique is to hold a press conference at which your business conveys a specific (and newsworthy) message to invited members of the press.

Publicity means exposure in the media and in public generated via a variety of methods, such as holding or participating in events, or making media appearances.

- family status (children or no children)
- geographic location
- ethnic group
- political affiliations or leanings, and
- hobbies and interests.

Use these criteria to draw a profile of your most promising potential customers, those who have a real need or desire for your products or services. A maternity store specializing in professional wear, for example, may identify its target customer as 25- to 40-year-old pregnant, married women in the legal, financial, and real estate industries, within a ten-mile radius of the store. A bike shop with a focus on single-track mountain biking gear might define its target customer as 18- to 25-year-old single males living within two miles of the local university.

Deciding how narrowly to define your target customer is more of an art than a science, but in general it helps to err on the side of being more specific. It's far more common for business owners to make the mistake of envisioning their customer base too broadly, making it very difficult to engage in effective marketing efforts. Remember: A solid definition of your target customer serves as a foundation for all your marketing activities. The more carefully you've defined your target market, the more likely your marketing efforts—even simple, low-cost methods—will bear fruit.

We'll discuss methods of researching and learning about your target customers in "Learning About Your Market: Market Research," below. For now, we'll focus on why defining your target customers is so important, and on how to develop a target customer profile.



TIP

Defining your target customers and learning about your market can be a circular process. Typically you'll start by identifying your best customer prospects based on your observations and intuition about your market (remember, your market includes not only customers, but also your competition and industry). Next, you'll want to do research to learn more about your market, such as what your target customers' buying habits are, what your competition is doing, or whether you can identify important industry trends. Based on this research, you might want to refine your target customer definition or refine your business idea to make the most of an unmet demand in the market. Learning about your market and adjusting your business plan accordingly is an ongoing process, and lies at the heart of running a business.



TIP

Defining a target market will not limit your business. New entrepreneurs sometimes resist defining a target customer base, thinking that it will somehow limit the business or reduce the number of potential customers. This is a misconception. For starters, identifying target customers in no way prevents a business from accepting customers who might not fit in the target. If a customer who completely does not fit your target profile walks through your door and wants to buy your product or service, great. But what's crucial to understand is this: Unless you have unlimited marketing resources, it's much more effective to focus your marketing efforts on potential customers who you have determined are *likely* to buy your product or service—and not waste your time and money courting the vast world of prospects who merely *could* become customers.

Bear in mind that some businesses focus on selling to other businesses rather than individuals. Selling products or services to other businesses (sometimes called B2B, for "business to business") can be lucrative, because businesses usually buy in larger quantities than individuals. If your business is targeting other businesses, you should still define your target customer, using characteristics such as:

- industry (restaurants, construction, banking, arts and culture, and so on)
- size, by number of employees or annual sales, and
- geographic location.

Evaluate Your Competition

Knowing your competition is just as essential as understanding your potential customers. The more precisely another business targets your specific customer base, the more important it is for you to develop compelling reasons for customers to choose your business instead of theirs.

When evaluating your competition, start with the businesses that are your closest, most direct competitors—the ones that target the same customers as you do. If you want to focus on a specific niche, you'll need to know whether other businesses are doing the same thing. If so, that niche might not have room for another business and you might want to find a different angle.

Niches that have little competition offer good opportunities for your business to be profitable. But a profitable niche that has little or no competition will likely not stay that way for long—competition will arise in any profitable market. Sometimes, in fact, being the first business in a profitable niche isn't an advantage. Other businesses can observe and learn from the experiences of a "pioneer" business and improve upon the business model, sometimes beating out the original pioneer. The moral here is that profitable markets either will already have competition or will develop competition. To keep your competitive edge, you'll need to stay current on what customers

Defining a Niche

The term "niche" is somewhat of a buzzword in business. A niche is essentially a relatively narrow or specialized market—for example, a maternity clothing boutique specializing in corporate/professional wear or a law firm that specializes in immigration cases. In a crowded marketplace, a niche serves the critical function of distinguishing you from your competitors.

Focusing on a niche can be an effective and profitable strategy for small businesses because it is often too difficult and costly to try to cater to very broad audiences. Instead of trying to appeal to everyone, a small business usually will do better to develop a specialty in an area that is not being fully served by other businesses, and exploit that niche with cost-effective marketing strategies.

A niche has an operational component and a marketing component. Operationally, you'll decide to what degree your business will tailor its products or services for the target customer base. Marketing to the target customer base means actively reaching out to this segment with your marketing efforts. You'll decide how much time and energy you devote to each component.

For example, a vegan catering business is heavy on the operational component of defining its niche: Its services (providing vegan meals) are completely dictated by its aim to appeal to the vegan market. Of course, it will also focus its marketing efforts on outreach to vegans.

In contrast, consider a day spa that mostly caters to local residents, but that recognizes an opportunity to boost business from the sizable number of tourists that come to its city. Though the spa's massage and other services might not be highly specialized for tourists, it could focus its marketing efforts on this niche by reaching out to the city's hotels, tour group companies, and travel agents. While its operations might not be wholly dictated by its goal of attracting tourists, it might make small operational tweaks, such as offering a free shuttle service to local hotels or including maps of local tourist attractions in its lobby area.

The point to understand here is that marketing to a niche usually involves a combination of operational adjustments to appeal to a target audience, along with directing your marketing to the niche audience. When you do both well, you'll be on your way to carving out a niche for your business.

Niches are by definition narrow, but not so narrow that they don't contain enough customers to sustain your business. The key to defining a profitable niche is to find an area where there is an unmet demand, and to fill that need with your products or services.

want and what the competition is offering. In addition, you'll want to know about industry trends, which we'll discuss next.

Know Your Industry

Your industry is not the same as your competition—rather, it's the broad world of businesses that operate in your general field, some of which may be competitors. Learning about industry trends helps a business improve its competitive edge by incorporating trends that aren't being adopted by its competition. It also helps a business avoid trouble, by knowing about trends that could pose a threat to the business.

For example, a restaurant should know about trends in the restaurant industry, which might include learning what is happening in New York and Los Angeles restaurants. For a restaurant in Austin, Texas, the New York and Los Angeles restaurants would not be actual competitors, but the Austin restaurant might want to read about their practices and experiences in order to learn valuable information about the restaurant industry. A trend such as eliminating foie gras from menus because of inhumane farming practices might be happening in New York and getting positive reactions from diners, but not happening at all in the Austin area. A smart Austin restaurant owner who is familiar with the trend could be the first to cut foie gras from the menu and reap valuable positive publicity.

Some trends can threaten entire industries, so being aware of them might be essential. The low-carb trend of the last several years was a serious blow for bakeries, pasta makers, and anyone serving or manufacturing carbohydrate products. The smart businesses learned about the trend and adapted their business strategies appropriately. Many restaurants began making rice or pasta optional in certain dishes, or offering burgers with gluten-free buns. For some businesses like bakeries, the best way to respond was to offer other products like expanded coffee and tea menus, or deli items heavy on meat and cheese. Others responded not by changing their product offerings but with marketing messages trying to convince customers that not all carbs are bad. Whatever the strategy, the key was to recognize the trend in the first place and respond in time rather than be blindsided by it.

General economic conditions are also important to your business. General forecasts for your city or region can give you an idea of whether economic upturns or downturns are on the horizon. The health of other key industries might also have a big effect on your business, even if you're in a completely different industry. For example, if you run a lunch cafe in an area where a major hospital is facing huge layoffs or closing, that will

certainly affect your business. Keep a broad view when evaluating market conditions that can affect your bottom line.



TIP

A profitable niche may exist in bucking a trend. For example, a technology might become obsolete, which could open a possible niche of serving the few customers who continue to use the obsolete technology. If you're the only electronics shop in town that fixes or sells turntables, you might have a profitable niche with little competition, even though turntables and vinyl records (while seeing a resurgence) are hardly a major growth industry. As with any niche, the trick is to make sure it is big enough.

Learning About Your Market: Market Research

Effective marketing starts with knowing key information about your market—your potential customers, competition, and industry. Doing market research is an important and effective way of testing your assumptions and answering questions you may have about your market. For example, if you want to open a coffee shop, you might be confident that the university area would be a great location, but not sure whether the students will be willing to pay a bit more for fair trade coffee. Market research will help you test your assumption about the location, and answer your question about pricing—and in turn give you valuable information upon which to base important business decisions.

The term "market research" tends to scare business owners, who think it means hiring pricey firms and conducting complicated demographic studies. In fact, market research can be much simpler and just as effective. Most small businesses can do their own market research with a very limited budget.

Market research can include primary and secondary research. Primary research involves doing studies with potential customers to find out how they feel about your product or service and your competitors' offerings, and to answer a myriad of other questions about their shopping habits and preferences. Secondary research involves studying what others have learned about your market; typically, this involves reading trade journals, other business publications, or reports generated from studies that others have commissioned. Small businesses often focus on secondary research because they find primary research intimidating. But as described below, small businesses can easily and inexpensively tackle primary research—and there's no substitute for the information you get directly from your target prospects.

Clarifying Your Research Objectives

The first step in doing market research is figuring out exactly what questions you want to have answered: What do you want to learn about your market? A very helpful way to go about this is to approach each aspect of your market— potential customers, competition, and industry—separately.

The table below offers a breakdown of the types of questions and research methods that would be appropriate for each group. It's not an exhaustive list, but illustrates how your inquiry will shift depending on what you're researching and what you're trying to answer.

Primary Research Tools

Though primary research might not be quite as easy as reading a trade magazine, it's very doable and will generally yield much more valuable information because it comes directly from your prospects. The way you ask questions of those prospects depends on your type of business and the product or service you're offering, but in general, you have three options: surveys and questionnaires, interviews, and focus groups. Let's look at each of these.

Using Surveys and Questionnaires

Presenting your target customers with surveys or questionnaires is a great way to answer questions you have about them. Start by identifying exactly what you want to learn; you can call these your research questions. Based on these research questions, you'll draft the actual survey questions themselves. It's a subtle but important distinction: Your research questions are not exactly the same as the survey questions. Instead, the survey questions should be crafted so they yield results that will help you answer your research questions. Your research questions will be more general than your survey questions, and you want your survey questions to be as specific as possible.

EXAMPLE: Solange plans to open a massage studio in San Francisco. She'd like to open it in the Nob Hill neighborhood because she thinks this neighborhood would appeal to her target customer base. To test her assumption, she creates a survey and distributes it via email to a list of contacts who fit her target customer profile. (We discuss developing email lists in Chapter 14.) Solange's research question is: "Is Nob Hill a good location for a massage studio?" To help her answer this fairly general and subjective question, Solange drafts more specific questions for the survey, such as:

- "Do you consider parking in Nob Hill to be a problem?"
- "Do you currently get massage services in Nob Hill, and if so, where?"
- "What massage services are currently lacking in Nob Hill?"
- "What would be the ideal neighborhood for you to get massage services?"

Market Research Questions and Methods		
Subject	**Questions to Answer**	**Methods**
Customers	• Who are your target customers? • What products/services do they need or want? • Where/how do they buy products/services? • What do they typically pay for your type of products/services?	**Primary Research Methods:** • Surveys and questionnaires • Focus groups • One-on-one interviews or inquiries of trusted contacts **Secondary Research Methods:** • Magazine or trade journal articles • Reports from previously conducted studies
Competition	• What do they offer? • What do they charge? • How do they provide the products/services? • Who are their customers? • What is their competitive edge?	• Primary sources (marketing materials, websites, and so on) • Trade shows • Networking • Magazine or trade journal articles
Industry	• What are standard practices? • What are the latest trends? • What does the future hold?	• Magazine or trade journal articles • Trade shows • Books

The survey responses indicate a great desire for a massage studio in Nob Hill, and only mild concern about parking. The primary complaint about the existing massage services is that they don't offer enough different massage styles, such as hot stone therapy. The survey results solidify Solange's decision to open her studio in Nob Hill, and help her tailor the services to her target audience.

You can send surveys in hard copy via mail, in plain text format via email, or—even better—by using a web-based service, many of which are free. At sites like SurveyMonkey (www.surveymonkey.com), you can create professional-looking online surveys, invite your prospects by email, and tabulate the results in useful ways, all for free. More features are available if you upgrade to a paying account, but the excellent free version is a great place to start.

Interviewing Prospects One-on-One

You can get information directly from individuals in a number of ways. One is simply to set up interviews with people whom you trust and who might have relevant opinions. For example, if you want to start a child care referral service, you could meet with people you know who have young children and ask them about their experiences. Or if you're starting a software company that will focus on data management for construction companies, set up lunch meetings with people you know in the construction business and pick their brains about their data management challenges.

Another way to interview people is to canvass them at locations where you are likely to encounter people within your target profile. A good example is going to a trade show related to your industry, standing in a high-traffic area, and asking people if they could answer a few short questions. The key here is to have just a few short questions that passersby could answer quickly with concise answers ("yes" or "no" or a numerical answer, for example), which you can easily record on a clipboard or laptop computer. Other locations might include special events that appeal to your target audience.

Working With Focus Groups

A focus group is an event at which you provide a presentation or demonstration to potential customers and solicit their feedback. You can gather feedback via a survey or questionnaire prepared in advance. Oral question-and-answer sessions and discussions among the group, which are recorded by someone taking careful notes, will also give you feedback. Examples of focus groups might include:

- a food manufacturer holding taste tests of a new salsa, asking participants to rate flavor and texture and to compare the new salsa to the competitors' versions
- a software company having users test their new time management application, asking them to rate it on ease of use and timing them on how long it takes to complete certain tasks with the software, and
- a nail salon demonstrating its signature pedicure on focus group participants, asking them for feedback on their experience during the pedicure and on the results.

While there's nothing inherently complex or expensive about conducting a focus group, it will require at least a nominal commitment of your time. If you don't have

a retail or other space, you might need to rent an appropriate venue. Because of the preparation and possible expense involved, start the invitation process early enough to ensure that you get enough confirmed participants to justify the time and expense of holding the focus group.

Getting Started: A Basic Approach to Primary Research

Now that you have an overview of primary research tools, here's a simple approach to help get you started:

1. **Start by identifying the questions that you want answered—your research questions.** In other words, specify exactly what you want to learn.
2. **Decide the best way to get those questions answered.** The basic methods include surveys, interviews, and focus groups (usually in conjunction with a survey or questionnaire). The methods you choose will largely depend on the types of questions you want answered and the nature of your product or service.
3. **If you'll be using a survey or questionnaire, draft the questions.** Your goal is to craft questions that will yield responses that will help you answer your research questions.
4. **Identify and invite your study's participants.** Start with your list of contacts and include people who fit your target customer profile. Build and expand your list by asking trusted contacts to suggest others who would be appropriate. Developing your list of contacts—particularly before you've started your business—is often a matter of networking, unless you want to pay for mailing lists. Networking is discussed under "Cost-Effective Marketing Tools," below.
5. **After conducting the study, compile the results.** Remember, doing market research is all about obtaining data, so don't neglect the essential task of assembling and analyzing your results.

Secondary Research Tools

Doing secondary research is generally as simple as reading trade journals and other business publications. It's something that all businesses should regularly do. Most businesses have at least one trade publication (many have several); identify the ones most relevant for you and read them as often as you can. Trade magazines tend to be expensive, so read them at your local library if it's not in your budget. Also, particularly if your business will mostly have local customers, read your local newspapers and other media to keep an eye on your local economy.



TIP

Read beyond the business pages. Valuable industry and other information is often found in other sections of your local newspaper. For instance, if you run a garden supply company, the home and garden section will have lots of information on trends and might feature other companies in your market. And an owner of a clothing store might find out about interesting fashion trends in the arts and culture section.

Effective Marketing Starts With a Solid Organization

Lots of small businesses fail to understand the importance of having an efficient, organized operation in place before they start their marketing outreach. After all, you'll want to be ready to handle the heightened attention your marketing will bring to your business. For example, a restaurant should not start a big marketing campaign without already having a good chef and enough well-trained waitstaff in place to handle a surge of diners. Otherwise, the unprepared restaurant's marketing efforts will likely result in unhappy diners and bad publicity.

Here's another way of saying this: Before you decide how to market, pay attention to what you're marketing. Make sure your house is in order before you call attention to it.

Cost-Effective Marketing Tools

You can market your business in endless ways—the key is to pick the methods that will give the most bang for the buck. Forget about the mega-budget strategies of the big businesses you see advertising on TV. The best bet for small to midsized businesses is to focus instead on building an excellent reputation and encouraging great word of mouth. Think about it: How did you choose a hair salon, plumber, or auto mechanic? Chances are that you asked your friends and acquaintances for a recommendation. Likewise, you want your customers to recommend your business to their contacts. The more that you can motivate your customers and clients to rave about your business, the more likely your business will be a success.

This section provides an overview of the many ways you can market your business, focusing on some key, tried-and-true methods: networking, media relations, special events, and listing your business in directories.

Networking

Networking involves actively cultivating relationships with people, businesses, community leaders, and others who present possible opportunities for your business—not just as potential customers, but also as vendors, partners, investors, or other roles. Networking is not the same

thing as sales: Rather than the simple goal of making a sale, the goal of networking is to connect with other businesspeople and influential people on topics of mutual interest and let them know what you do, in hopes that they will recommend your business to their circle of contacts.

Lots of folks new to the world of business fear that successful networking requires unsavory schmoozing or pandering. These concerns are unfounded. In fact, if you adopt an aggressive, cluelessly self-centered approach, you risk alienating the very people whom you want to make your allies.

Successful networking is in fact little more than sincere communication with others on topics related to your business. You are "networking" every time you attend an event held by a local trade association, get to know other business owners and community leaders, write a letter to the editor, participate in an online discussion group, or have lunch with another local business owner.



TIP

Forge relationships with contacts before you need help from them. For example, if you need the support of a local politician on an upcoming city zoning decision, you'll have a better chance of getting the politician's vote if the lawmaker already knows you and thinks favorably of your business than if you place a call to their office out of the blue.

While it may be easiest to meet someone at an event, introducing yourself to a potentially useful contact can be as simple as picking up the phone, writing a letter, or sending an email. If there's an opportunity to tie your message to a timely event, lead with that. For instance if the contact was recently mentioned in local media, or won an award, you can say something to the effect that you wanted to connect to send your congratulations.

In making your initial contact, you should be as formal or informal as is appropriate for the person with whom you are making contact. A letter of introduction on attractive letterhead might be best for an influential politician, for example, but a phone call might be fine to introduce yourself to a local business owner. In explaining who you are, describe your business clearly and briefly. Try to conclude by encouraging further communication, such as inviting the contact to an event or to a coffee meet-up. If you talk to people on the phone, a follow-up email or letter thanking the contacts for their time is always a smart idea.



TIP

Check out online networking. Social media, such as LinkedIn and Facebook, offer lots of opportunities for networking. See "Social Media: Facebook, Twitter, and More," in Chapter 14, for details.

Media Relations

Media coverage in newspapers or magazines, or on radio, television, or the internet, is another excellent—and inexpensive—way to promote your business. Your goal is to get "editorial" coverage, meaning some mention of your business or event in news or feature stories (as opposed to paid advertising). Because editorial coverage is far more credible than advertisements or paid publicity, it will have a greater impact. For example, a local newspaper article about your business being awarded a lucrative state contract will almost always generate a more favorable and lasting impression than any advertising.

The term "media relations" means the process of attempting to obtain editorial coverage. It is a fairly simple process: You contact the media on behalf of your business and encourage an editor, producer, or reporter to write or produce a story about your subject. As with most marketing efforts, the more specific and targeted your message, the more impact it will have. For example, you'll be much more likely to interest an editor in your business's recent expansion and opening of a new facility than of the very general fact that your business exists.

The basic steps for conducting media relations are:

1. **Write a press release.** A press release is a key tool to use when pitching a story idea. Typically, a press release is a one-page announcement outlining the information you want the media to cover. You have two goals in writing a press release: (1) to capture the journalist's attention, and (2) to make it easy for the journalist to write the story you want published. Stylistically, press releases are usually like news stories, offering journalists an example of the story you want them to produce. (See "Elements of a Strong Press Release," below, for more details on how to put together a winning pitch.)
2. **Make initial contact with the journalist by phone.** Make a preliminary phone call before sending a press release, so your release doesn't get lost in the shuffle. If you don't know which reporter would be likely to cover your story, call the news department, briefly describe the nature of your press release, and ask who might be the best person for you to contact. Once you have a name of a reporter, an editor, or a producer, give that person a call to introduce yourself and your business, briefly explain the nature of your news story, and tell

the person you will be sending a press release. If you can't reach the journalist by phone (as is often the case), don't let it hold you up: Leave a message and send out your press release. While you could make this initial contact by email, a phone call makes a stronger impression. And creating lasting relationships with individual reporters is the best way to get positive coverage over the long term.

3. **Send the press release by email, both as a PDF attachment and in the body of the email.** Years ago, press releases were sent by mail. Then, for years it was all about delivery by fax. Today, it's typical to send press releases via email, ideally both as a PDF attachment and as plain text in the body of the email. Emailed press releases work best because reporters like having an electronic copy from which to cut and paste when writing their stories.
4. **Follow up after you send the press release.** Shortly after sending your press release—a few hours or a day later, depending on the timing of your announcement—follow up with another phone call or email to make sure your press contact received the release and to answer any questions.

An example of a press release is shown below.

Some people feel timid about contacting the media and asking them to cover a specific story. While you shouldn't be a pest, you also shouldn't feel shy about pushing your story idea persistently. To do their jobs, journalists must come up with a constant stream of interesting new story ideas. Local business journalists are often particularly challenged in finding newsworthy business stories. Just as you need their help, they need yours. Because you will often know more than reporters do about a particular story, you can offer valuable information that they can use. If you are honest and reliable, you will usually be treated with respect.

If you don't get a response after an introductory phone call, a press release via email, and a follow-up call, it might be because the journalist did not think your story was newsworthy, or other stories were more compelling. Let your idea rest; doing so will help you preserve your reputation as a pleasant, professional person to deal with the next time you want to pitch a story. A few months later, when you try again, you could be pleasantly surprised to find that you've pitched the right story on the right day.

Elements of a Strong Press Release

The better your press release, the more likely a journalist will write about your business, giving you valuable exposure in the press. Reporters, editors, and producers are chronically busy and squeezed by deadlines; they need good story ideas and clear information to get their jobs done. The easier you can make it for them to cover your story, the more likely they are to oblige. If you write a strong, clear press release, they might even use parts of it verbatim. But you'll need to keep your press release as succinct as possible.

Here are some tips on how to construct a compelling press release that is likely to generate media placements:

- **Start with a news hook.** Like a news story, your press release should have a strong first sentence, known as the story's "lead" (sometimes spelled "lede"). What is the most important point you want to get across? Write it in a clear, straightforward style and you will have your lead.
- **Date, time, and location information should be easy to find.** If your press release is promoting an event, don't bury important information deep within long paragraphs. Include important event details such as date, location, and registration deadlines in the first sentence or two or summarized in bullet points at the end.
- **Include the most important information first.** Your press release should include all important details up front, then work toward more general or background information in later paragraphs.
- **Include quotes from yourself or other key people.** Reporters like to include quotes from real people in their stories, so include at least one or two catchy quotes in your press release. If you are the best person to offer a quote, don't be shy about quoting yourself! It might feel strange, but it's perfectly appropriate. Remember, you're offering the media a sample of the story you want them to write, so include a quote as if an outside reporter interviewed you.
- **Include a separate section with contact information.** The journalists who receive your release might have additional questions to ask you. Choose a point person who will be available to field any questions, and clearly include contact information at the end of the release.
- **Create a news angle.** If it is appropriate and possible, tie your release into a topic that's currently in the news. For example, if your press release is announcing your furniture manufacturing company starting a new line featuring environmentally friendly materials, you'd certainly want to include a reference to the rapid growth of "green" businesses—a hot news topic.
- **Use statistics.** Reporters love statistics that show how prevalent a problem is or how many people are affected by an issue. Using the previous example, you could include recent statistics that 35% of people surveyed would be willing to pay a premium for environmentally friendly products.

Sample Press Release

FOR IMMEDIATE RELEASE
May 6, 2024

State of Illinois Contracts with Data Solutions, Inc. for Data Communications Equipment and Services

CHICAGO, Illinois—The State of Illinois has entered into a purchasing contract with Data Solutions, Inc. for a wide array of data communications equipment, related software, and Data Solutions' award-winning network management services. Under this agreement, the equipment and services provided by Data Solutions will be available at special volume pricing to all Illinois state agencies, municipalities, and educational institutions.

"We are thrilled that the State of Illinois has chosen Data Solutions to fill its data communications needs," said Data Solutions CEO Steven Dutch. "As a growing Illinois company, we are proud to play a role in keeping technology money in the Illinois economy."

Illinois's contract with Data Solutions will allow state procurement agencies to support and enhance their data communications networks with the highest-quality products and support services. In addition to the data communications equipment included in the purchasing agreement, Data Solutions' engineers will be available under this contract to provide analysis, design, installation, training, and maintenance services for the equipment included in the contract.

The agreement will be effective until December 31, 2026.

About Data Solutions
Data Solutions is a privately held Illinois-based company specializing in the design, implementation, support, and management of voice, video, and data communications infrastructures. Data Solutions offers unparalleled expertise in IP-based networking, including LAN, WAN, and IP multiservice technology. Data Solutions is headquartered in Chicago and has a second site in Milwaukee, Wisconsin. More information about Data Solutions and its award-winning products and services is available at www.datasolutionswebsite.com.

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TIP

Relationships with media people are gold. The most effective media relations come from relationships you build with reporters, editors, producers, and other media contacts. Because you are more likely to get news coverage from a reporter with whom you've worked than from someone who's never heard of you, always treat your relationships with people in the media as the valuable resource they are.

Finally, keep in mind that having a story written about your business isn't the only way to get media coverage. Another great way to get exposure is to be interviewed and quoted for articles on subjects in which you have expertise. Ideally, you'll develop relationships with reporters who will understand you to be an expert in a certain area, so that they call you for a quote when covering that topic. Similarly you might be invited to participate in a local TV show or podcast on a topic within your expertise. Foster this type of coverage by making sure your media contacts understand your area of expertise, and know that you are willing to offer your opinions and information if they need them for a story.

Special Events

Holding events such as a grand opening party, a product demonstration, an informational workshop, or a holiday gala will help you forge a close bond with your customers, while simultaneously generating valuable publicity for your business.

Special events tend to grab the attention of the media, making the event a particularly effective marketing method. The icing on the cake is that events can (and should!) be fun, for both you and your customers.

One reason that special events are such effective publicity tools is that the media is generally more responsive to specific, time-sensitive activities or events than to the business in the abstract. An event is an easy hook, particularly when there is any educational or public interest component to your event. For example, if your housewares store offers a half-day workshop on how to make your home more green, a reporter might be able to craft a story around the event and discuss the timely topic of sustainable living.

Even if your event isn't newsworthy enough to merit a whole story, most events can be listed in local business calendars, usually for free. Most daily papers have a business section with event listings, and submitting your event is an easy way to get a dose of publicity.

Listings or Directories

Getting your business listed in appropriate directories is a great way to boost your visibility with your target customers. Listings work so well because consumers who

consult a particular directory or directory category have already determined that they are looking for a specific type of business. Most communities have lots of directories—for example, the local chamber of commerce membership directory, a directory of women-owned businesses, or the African American business league's directory. Some directories are published in hard copy, though most directories are posted online.

Most business directories charge fees. You'll have to evaluate whether the fees fit into your budget and whether the directory exposes your business to the right audience. While most directory fees are modest, some are prohibitively expensive; these are not worth considering unless the audience you're trying to reach is extremely narrow and desirable, and the directory is highly targeted to that audience.

Note also that some membership organizations include a directory listing as a benefit of membership. Chambers of commerce, for example, will typically list member businesses in their directories—print, online, or both. As with regular directory fees, you'll have to judge whether the directory listings (plus any other benefits) are worth the membership fee.

With any kind of directory, the most important consideration is what audience the listing will reach. Ask about traffic statistics for online directories, or distribution locations and numbers for print versions.

To find all of the directories in which you should list your business, you'll have to do some homework. Looking online is a good start, but you should also check with local resources, such as local government offices, chambers of commerce, economic development organizations, and trade associations.

Sponsorships

Sponsoring an event, sports team, nonprofit organization, or public television or radio station is a great way to develop your brand. Sponsorships are a lot like advertising in the sense that you pay money in exchange for having your business recognized in some way, usually with a display of your logo and sometimes a short marketing message. But unlike advertising in traditional media like newspapers or television, a sponsorship does more than just communicate your marketing message: It also conveys a sense of connection to whatever you are sponsoring and thus creates more positive associations in your potential customers' minds.

For example, if you sponsor a local golf tournament and have your logo prominently displayed on signs, event schedules, and other materials, the golf-oriented attendees will start to see your business as an ally and begin to develop an emotional connection to your business. Similarly, a business that sponsors an LGBTQ film festival will develop a connection to the LGBTQ community.

Sponsorship opportunities tend to fall in a few categories:

- **Events.** This includes events such as sport tournaments, film festivals, trade shows, street fairs, concerts, and just about any other event open to the public. Event organizers often want businesses to help fund their events in exchange for recognition, usually on signs, in printed materials, and in TV or radio ads.
- **Facilities.** New building projects, such as sports arenas, courthouses, or university buildings, sometimes ask for corporate and business sponsors, who are often recognized on a plaque, statue, or other sign in the building. Being recognized in this way helps show your business is a pillar of the community.
- **Nonprofit organizations.** Most nonprofits welcome sponsorship funds from businesses and will have specific benefits available for different levels of financial support. Sponsoring a nonprofit is an excellent way to build your reputation in the community served by and involved with the nonprofit.
- **Public television and radio.** You'll typically reach a more affluent, educated demographic via public media than you would with commercial stations.

Email Outreach

First off, we're not talking about spam here. Thoughtful, strategic, and ethical email outreach is a tried-and-true way to let your target customers know about upcoming promotions, events, and other business information. This approach involves sending useful information to a list of people who have indicated a desire for your emails. See "Email Marketing" in Chapter 14 for an in-depth look at email promotions.

Direct Mail

"Direct mail" means sending paper marketing materials through the mail. People often perceive direct mail campaigns to be complex and expensive, and they can be both. However, direct mail campaigns can also be simple, targeted mailings that are effective without costing a fortune. If you keep the materials simple and develop your own mailing list instead of paying a firm for a list, you can engage in a direct mail campaign that's both thrifty and effective.

First, decide on the goal and subject of your direct mail campaign. As with most types of marketing outreach, the more specific your message, the better. Instead of sending out a general brochure about your printing business, for example, send out a postcard offering a 50% discount off

the first order for new customers. Special promotions, discounts, or giveaways are the best ways to capture people's attention amid all the junk mail.

You can take different approaches in developing your mailing lists, from simply compiling names of everyone you know and looking up their addresses to hiring a mailing list firm and paying a fee for a list. You might be surprised at how many names you can come up with on your own. Start with the people within your target customer profile and work outward. Ask your friends for names of people they know who might be interested in your business. If you'll be targeting other businesses, scan other directories for their contact information.

Creating the printed materials for your mailing can be more affordable than you might expect. You don't need to produce a high-end direct mail package like the ones you get in your own mailbox, printed in full color on heavy paper with special die-cut shapes and other frills. Instead, focus on creating simple layouts of text and graphics on standard-sized pages or postcards. Ideally, you, a partner, or an employee can design your materials in-house, using relatively inexpensive software such as Adobe *InDesign*. Alternatively, a professional graphic designer can be immensely helpful, particularly if no one in your business has graphic design skills.

Samples

Everyone loves stuff for free. If you have a product that lends itself to being sampled, consider setting up a table at a trade show or another venue and offering freebies to the public. Sure, you'll always end up giving things away to people who have no intention of buying your product, but it's usually worth it to forge a connection with even a few potential buyers. Some examples of offering samples effectively include:

- a handmade soap maker offering small slices of their beautiful soaps at a table in the health food store
- a coffee shop offering small free cups of their house-roasted coffee at a street fair, and
- a massage studio offering free five-minute massages at a local trade show.

When offering samples, prepare in advance to ensure that you make a powerful and positive first impression. Have your business name and logo prominently displayed. Have business cards or brochures available so that the people sampling your product or service can find you later.

Customer Loyalty Programs

The phrase "customer loyalty program" sounds much more involved than it really is. What we're talking about here is implementing ways to keep your current customers coming back for more. Here are a couple of ideas:

- **Offer punch cards for repeat customers.** After a number of purchases—measured in either units or dollar increments—the customer gets something free. For example, a coffee shop might offer a customer a free cup of coffee after they have purchased ten cups, tracked on the punch card.
- **Include freebies with each sale.** A shoe store, for example, could include a small tin of shoe polish with every order. A store selling items for newborns could include a free rubber duckie with each sale. It's amazing how much customer goodwill you can generate by including something worth about 10¢ in each sale.

Print Materials

Brochures, business cards, flyers, letterhead, postcards, bookmarks, and other printed materials can help you spread the word about your business. It might be worth hiring a professional graphic designer to create these materials to ensure they convey a professional image. It's also important that your logo and other imagery remain consistent across all the media you produce, both in print and online.

Websites and Social Media

Every business should have at least a simple website with basic marketing information. These days, if customers Google your business and come up empty-handed, they might think your business isn't very professional or stable and might keep looking, choosing a competitor that has a useful site. In addition you can network on social media channels such as Instagram, Facebook, YouTube, and countless others. Read Chapter 14 for guidance on how to establish your business online and effectively network within online communities.

Publishing Articles or Newsletters

Newsletters and articles—both print and email versions (discussed in Chapter 14)—are powerful marketing vehicles, particularly for professional service businesses. These materials help strengthen your relationship with existing clients and broaden your customer base when existing customers pass on the newsletter to their friends and family. Accountants and lawyers, for example, are perfect candidates for newsletters because the heart of their businesses is information.

On the flip side, newsletters do require a fairly sizable time commitment, and possible expenses if you need to hire someone to help. Writing and editing are time-consuming tasks (even for professional writers), and you might need to hire a designer for the layout work if you plan to distribute a hard copy version.

Also bear in mind that by its nature, a newsletter is distributed periodically, so if you can't commit to whatever time frame—typically weekly, monthly, or quarterly—then don't do it at all. Starting to send a monthly newsletter and then have it disappear after six months will give a much poorer impression than never offering a newsletter in the first place.

If you really want to publish but can't commit to a newsletter, consider publishing occasional articles on topics of your expertise. Many opportunities for writers are available online (for example, some lawyer directories include articles by lawyers who have signed up for the directory). Or consider sticking with marketing copy rather than substantive information. Putting out regular flyers or emails highlighting your products or services and special events at your store is much easier than a substantive newsletter, and might be all you need.

Chapter 13 Checklist: Small Business Marketing 101

- ☐ Define your target market—potential customers, competition, and industry—and learn everything you can about it. Based on what you learn, you might decide to tweak your target market or aspects of your business operations in order to better appeal to a profitable customer base.
- ☐ Engage in primary market research to get information directly from your potential customers. Web-based surveys are excellent tools to use.
- ☐ Have an efficient, organized operation in place before you start your marketing efforts.
- ☐ Focus on marketing strategies other than advertising—particularly on ways to encourage good word of mouth—that are usually less expensive and just as effective.
- ☐ Network by cultivating relationships with other businesses, community leaders, and others.
- ☐ Develop relationships with reporters and editors and pitch newsworthy stories about your business to them. Make your expertise clear to media people so that they contact you for quotes or interviews when writing stories on certain topics.
- ☐ Maintain at least a simple website and network online.

CHAPTER

14

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Your digital strategy is your plan for marketing your business online and, if you'll be selling products online, how you'll handle e-commerce.

Whether you want to send out simple marketing emails for your interior design business or you need a robust e-commerce operation for your online pet products company, this chapter will help you develop a realistic strategy for selling and marketing online.

We'll discuss a wide range of e-business issues, including:

- how to develop a digital strategy that complements and supports your business strategy overall
- the best methods and tools to promote your business online, including email marketing, blogs, and social media
- how to drive traffic to your site and convert those visitors into customers
- details involved with e-commerce (online sales), including merchant accounts, payment gateways, and shopping carts
- how to evaluate alternatives, such as template-based website builder services or opening an affiliate store with e-commerce sites like Amazon, eBay, or Etsy
- the basics of registering your domain name and setting up a hosting service, and
- legal rules governing ownership of and copyright to your site's content.

Digital Marketing: Your Online Presence

Before we get into specific marketing tools and techniques, let's consider your overall online presence. By "online presence," we mean all the places a customer or potential customer might encounter your business. These places include:

- Your website, which might include a blog.
- Any site where customers can buy your product or service, such as an Amazon store, Etsy store, or Fiverr profile.
- Social media channels (Instagram, Facebook, YouTube, Reddit, etc.). This is often where businesses are the most active with their marketing communications. Some social channels like Facebook allow e-commerce directly from the social channel, without having to direct visitors to a separate online store.
- Your Google Business Profile, which provides information about your business to people searching for that kind of business. Customer reviews at your Google Business Profile can have a major impact on sales.
- Review sites like Yelp or TripAdvisor where customers can post reviews and your business can respond.
- Listings in various directories, such as local chambers of commerce or trade

associations. Many organizations host directories as a tool to steer customers to their member listings.
- Publishing platforms like Medium or Substack where you post regular articles or essays, either in the voice of your business, you as the owner, or a different staffer(s) tasked with writing duties.
- Trade-specific forums, like a Google Group or LinkedIn Groups for members of an industry.

It's easy to become overwhelmed with the need to have a compelling website and multiple social media accounts to market your business. As you start your business, you might want to go slow by picking a couple channels that you think you can manage well, without worrying about the ones you're not using. Over time you'll figure out whether you're missing out on opportunities on other channels, and if so you can always shift your efforts. It's a mistake to try to cover too much at once, unless you have a hefty marketing budget with an experienced team. Most start-ups aren't in that position.

Digital Marketing: Your Message and Brand

Before you can decide where and how you want to market online, you need to decide what you want to say. What's your message for folks looking at your business online? No doubt, you'll want to promote specific products or services. But you might also want to establish your business as a source for information for customers and potential customers, apart from directly promoting a product or service. For example:

- A bike-rental company aimed at tourists might post regular updates about upcoming city festivals. It might do so via blog posts, email updates, or with a public calendar of events.
- A tech company might share blog or social media posts about new developments in artificial intelligence, or the latest core updates in platforms like WordPress or Squarespace.
- A wellness consultant might share recent research reports about anti-inflammatory diets or approaches towards managing long COVID symptoms.

Besides the substance of the messages you plan to share, you'll also want to be consistent with tone, images, and other brand elements. As discussed in Chapter 13, branding is the process of establishing associations in your audience's minds and hearts about what your business is all about.

Now let's talk about specific marketing tools, beginning with your website.

Internet Jargon: Defined

Here are definitions of some of the most common terms related to online marketing:

- **Blog** is short for "weblog," a section of a website composed of short posts, ordered in reverse chronological order (as in, the most recent post at the top of the page). Blogs often include links to other sites, and are regularly updated—frequency varies a lot from site to site—by one or more contributors, called bloggers. Blogs began as largely personal communication vehicles, but an increasing number of reputable businesses and online publications use the blog format.
- **Crowdfunding** is a method of raising money online directly from your social media network and other supporters. Crowdfunding websites (also called "platforms") like Kickstarter or Indiegogo make it easy for users to create fundraising campaigns that can be promoted among social media networks, such as Facebook or X (formerly Twitter). See the "Crowdfunding and Social Media" section in Chapter 5 for more on the subject.
- **Digital platform** refers to a business model centered upon a website that serves as a hub for customers, and sometimes for multiple user groups. Uber, for example, is a marketplace platform for riders and drivers. Slack is a communications platform for remote teams. Facebook is a social media platform where users, advertisers, and app developers interact.
- **E-commerce** refers to an online sales operation, generally via a website that is set up to allow online orders and process credit card or other types of payments.
- **Email lists** are compilations of email addresses of people who have expressed interest in receiving promotional emails from a business. (If the content of the email is substantive in nature, the email would usually be called an e-newsletter.) For example, your business could send emails about special promotions or events to an email list. The recipients included in an email list must have clearly expressed interest in receiving the emails—unsolicited marketing emails are spam and frowned upon by savvy businesspeople and their recipients.
- **Listservs** are email discussion groups about specific topics, which allow people who have signed up to share information. Any subscriber can send an email to the listserv, and that email will automatically go to all listserv subscribers. Automatic distribution differentiates a listserv from an email list, in which communications are typically only one-way from the administrator to the list.
- **Online presence** refers to the many ways a business participates in the online world. For instance, in addition to having a website, you could maintain a blog; manage Facebook, X (formerly Twitter), and Instagram pages; be listed in numerous online directories; be a regular commentator on other blogs and online forums; have a regular email newsletter; supply informative articles to other websites; or moderate a listserv. The sum of all these activities is often called your online presence.

Internet Jargon: Defined (continued)

- **Social media** is a general term referring to networks of users such as Facebook, X (formerly Twitter), Instagram, or LinkedIn. Businesses can promote themselves and develop their brands by strategically engaging in these channels.
- **Web developers** specialize in all aspects of creating websites, including organizing the information, graphic design, and programming. Avoid the term "web designer" when referring to these individuals because graphic design is only one aspect of creating a website. Another acceptable term for web developer is web builder. Although some web developers work alone as independent contractors, they typically involve teams to create a website: strategists, information architects, graphic designers, content developers, and programmers.

Starting Point: Your Website

While some businesses forgo a website in favor of a business page on Facebook, most maintain at least a basic page containing a description of the business and contact information. Even an ultrabasic site can help your business in several ways, including:

- **Projecting a professional image.** Some customers consider businesses that don't have websites to be less serious or less stable than businesses that have them.
- **Reaching the ever-growing number of consumers who look for businesses online.** In our increasingly internet-reliant population, a growing number of people start their searches online for a local plumber, a café, a clothing store, or any other type of business.
- **Communicating more information than you can typically fit on a business card or brochure.** When you include the URL of your website on your business cards, brochures, or other printed materials, potential customers can go to your site for more in-depth information, such as product details or portfolio pieces.
- **Creating a permanent place where you can post information that potential customers can always refer to—unlike brochures or business cards that often get thrown away or lost.** This can be helpful to current customers or clients who may need to look up your phone number or payment mailing address.
- **Facilitating word-of-mouth marketing.** Your happy customers will easily be able to share information about your

business to their friends and family simply by sharing your URL.

- **Marketing your business without paying print costs.** Besides being less material-intensive, online marketing can save you a lot of money if the information you want to communicate is lengthy or changes frequently, such as sales, specials, and new product arrivals.
- **Developing and refining your marketing messages before committing them to print.** For example, you could create a simple three-page site with information about your services, your professional biography, and contact information—and refine these pieces of content for a month or two until you're satisfied with them; then create a print brochure with the information from the website.
- **Creating a central place where all your marketing activities—both online and offline—can be listed and linked.** For instance, your site can (and should) offer links to your Facebook, Instagram, and YouTube pages; a sign-up form for your email list; and a calendar of special events or workshops your business is hosting.

A website might offer even more opportunities for your business, such as the potential for profits from e-commerce and innovative customer service. The bottom line is that even the simplest website will be an asset to your business. If more expansive online engagement efforts fit into your business strategy, a website will serve as an important base of online operations.

We discuss approaches to website development later in the chapter. First, let's explore other online marketing tools and techniques.

Other Online Marketing Methods

This section discusses the methods businesses commonly use to promote themselves online in addition to their websites. These methods evolve as new technologies are developed, so it's important to monitor trends and adapt your approach as circumstances warrant.

Email Marketing

Staying in touch with your customers and potential customers via email offers loads of possibilities and potential, but it also requires a commitment to ongoing outreach. If, like many business owners, you find you don't have the resources to regularly engage in email marketing, you're not alone. What I'll describe in this section is a basic approach to work towards, which you can build upon as your resources grow.

One of the first questions to consider is what kind of information you want to send to your current and potential customers. Broadly speaking, you can send either purely "marketing" information or more substantive information. The latter strategy is often called "content marketing." Purely "marketing" information tends to be things like promotions, coupons, and other information that is closely targeted towards a sale. Content marketing, on the other hand, tends to feature lengthier informational material that is of interest to your customer base. Of course, the line between marketing and substantive information can get pretty blurry, so here are some tips on how to communicate both types most effectively.

For promotional emails, sales and discounts are always good fodder. Even better, structure the promotion so that members of the email list get something extra—like an early-bird notice, "email list only" sale, or an additional discount—which can really help get customers in your door. Everyone loves to feel they're part of an exclusive group with special access or deals.

Here are some simple examples of promotional emails:

- A clothing store sends a promotional email a week or so prior to any big sales. Twice a year it has an "email list-only" 50% off sale on a Sunday (when it is usually closed) for members of the email list. Later, when the store increases its staff, it starts a quarterly e-newsletter covering fashion trends.
- A local comedy club sends a monthly promotional email highlighting the upcoming month's comedy acts at the club. Weekly dinner specials are also included. The email contains an "Email Exclusive Coupon" for half off a dinner with the purchase of another dinner.
- A spa sends an occasional promotional email with package deals, such as a Valentine's Day couples massage special; a Mother's Day massage and facial package; or special discounts to celebrate the spa's fifth year in business.
- An imports store sends out an email a few days before the arrival of a new container, alerting recipients to the new inventory.

A newsletter can be a great way to market your business. Be sure that your "newsletter" lives up to the name: a so-called newsletter that is little more than promotional copy for products and services will disappoint and annoy customers expecting more substantive information. Here are a few examples of good newsletter content:

- A photographer's e-newsletter includes practical photography tips, such as how to photograph children, use props, or shoot in low light.

- An independent cinema sends a monthly e-newsletter with schedules and descriptions of upcoming screenings. The cinema writes its own descriptions of and commentary about the films, so it feels justified in calling these e-newsletters.
- A landscaping service sends a monthly e-newsletter with gardening tips for the upcoming month, such as when to prepare the soil, what seeds to plant, and how much to water.

With any of these, it's entirely appropriate to include some promotional copy or links, ideally towards the end of the newsletter.

Of course, a successful newsletter needs to be both topical and well-written. Make a realistic evaluation of whether you or a staffer has the writing skills and the time to reliably create a quality newsletter. If not, seek outside editorial help or consider putting off your newsletter plans until you have the resources in place.

When sending out any type of email to your customers, manage your email lists scrupulously. Managing hundreds or thousands of email addresses—including dealing with undelivered email (due to incorrect email addresses), address change requests, and unsubscribe requests—is no easy task. Using an email marketing service such as MailChimp (www.mailchimp.com) or ActiveCampaign (www.activecampaign.com) will help avoid mistakes that can cost you customer goodwill.



CAUTION

Avoid spam at all costs. To avoid being perceived as a spammer, send mass emails only to customers who have asked to be on your list. If you want to demonstrate a further commitment not to send spam, consider using a "double opt-in" system. In it, customers opt in the first time by indicating a willingness to receive your email communications—perhaps they signed up for your list at your website or signed a sheet at a tradeshow event. Then, you send an email to individual recipients asking them to confirm that they want to be included on your list.

Blogging

You might hear that blogs are no longer relevant or useful when it comes to marketing your business. Not so. Blogs remain an easy and effective way to share your knowledge with customers and others. A blog is a collection of chronologically ordered posts with the most recent entries at the top, much like an online journal. Photos or images are often included with individual posts. Posts tend to be short and almost always include one or more links to related information at other websites. In addition, many blogs allow readers to post comments. Inexpensive

and free blog software (WordPress is one of the primary ones) makes it easy to add new posts.

The trick to a successful business blog is to offer information that's interesting to your potential customers and that favorably inclines them toward your business and products or services, without being too self-serving or marketing heavy. Blogging is a powerful way to build your brand and solidify your relationship with current and potential customers. For example, if all your business blog posts are about how great your business is—and even worse, if it's all in marketing speak—you'll quickly turn off readers. But if you present interesting topics or beautiful photos to your readers in a sincerely helpful, information-sharing way, you'll be more likely to attract regular readers who develop a favorable impression of your business. You might even occasionally link to competitors, if appropriate.

Blogs that allow users to post comments tend to develop a more loyal readership. However, allowing reader posts means you will have to monitor those comments for offensive, libelous, off-topic, or otherwise unacceptable material. It's up to you on where you draw the line, but inevitably you won't please everyone. If you leave offensive posts untouched, visitors will likely be turned off; while if you edit posts, people are sure to complain that you're censoring them.

Here are some examples of business blogging that could enhance a business's messaging:

- a bakery's blog offering baking techniques and tips, allowing comments from readers and encouraging readers to submit photos of their results
- a yoga studio's blog about the health benefits of yoga and tips for doing various poses correctly, as well as links to external articles and studies about yoga's role in healthful living, and
- a landscaping company's blog sharing its experiences and projects, with photos of gardens as they grow, tips on gardening and landscaping, and links to sites with helpful information and quality products (such as seeds or landscaping materials).

Social Media: Facebook, Instagram, and More

Social media, with its focus on user-generated content, dominates the internet. Tens of millions of users are active on sites like Instagram, Reddit, Facebook, and X every day.

A business engages in social media by creating an account in the name of the business, then networking in the ways that are appropriate within that community.

Here are some tips, ideas, and examples of how to market through social media (the possibilities are endless).

Implement a Comprehensive Social Media Strategy

As with any type of marketing, using social media to promote your business is best done with a well-thought-out plan and a clear idea of where you'll focus your efforts. Figure out which social media sites will work best for your business and what your communication goals are before jumping in. Keeping your strategy firmly in focus will also help you avoid being swayed by overhyped technologies that might not be a good fit.

Use Social Media Sites That Your Audience Uses

While sites like Facebook have enormous and broad audiences, others are more specific—and valuable—to certain industries or business types. For example, if you're a freelance photographer, consider having an Instagram or Flickr account. Because photographers tend to congregate at these sites, knowledgeable clients (like wedding planners or PR agencies) often go there to find good photographers and check out their work. If you don't have an account with photos showing your best work, you'll be missing some potential opportunities.



TIP

Social media channels are good places to check out your competition. You can learn a lot about what customers think of them and how you might attract those customers to your business. Looking at the complaints, you might also learn what *not* to do!

Understand the Ins and Outs of an Online Community

If you're not already an experienced user of a social media platform, be sure to look before you leap. Create a user account for yourself personally to learn how the community operates. Learning the conventions and customs that others use will help you avoid making a faux pas—more than just embarrassing, these kinds of missteps can damage your business's reputation and cost you customer goodwill.

Be Creative!

From creating a hilarious or insanely clever YouTube video that goes viral to finding novel ways to use Facebook Messenger for customer service, there's no limit to the ways you can use social media for your business.

Keep an Eye on the Horizon and Shifting Trends

The roadside is littered with the husks of once-hot social media sites that fell victim to the next big thing. Remember MySpace? Or the online coupon and daily deal site Groupon? As the fates of these sites show, it's important to keep an eye on social media trends so that you know when to join, and when to quit, a platform.

Google Business Profile

An easy and important way to market a brick-and-mortar business online is to make sure it is listed accurately with local search services such as Google Business Profile. Doing this makes your business appear on maps when people search for your kind of business in your city. If you don't have a listing or it's not accurate, your business may not show up—or it may appear in the wrong location, resulting in irritated customers who are driving, biking, or walking all over trying to find you.

If, on the other hand, you have a clear, accurate, and compelling listing, you have a solid chance of attracting searchers to your business. With Google, your listings can contain your address, phone number, website, hours of operation, and more information including photos and videos. You can even create coupons—for free—that will appear next to your listing that customers can print and use. There are lots of additional free and pay-based services, but it's important (at a minimum) to claim your listing and make sure it's correct.

Note that accuracy is an issue because Google has created millions of listings using public data sources such as phone directories and other websites. These listings are initially "unverified" until the business owner "claims" the listing, at which point the business owner can edit the information and make sure it's correct. The vast majority of Google listings are unverified, which at a minimum means that those business owners aren't taking advantage of a powerful and free resource. It's worse if the unverified listing has the wrong address or other errors. Worse still is the possibility that your unverified listing can be hijacked by spammers and sleazy competitors. Google is tightening its rules and security, but many businesses have fallen victim to this—which could have been prevented if they had claimed their listings.

To claim and manage your Google Business Profile, go to www.google.com/business. It's free, but you'll need to create a Google account if you don't already have one.

Online Ads: Pay Per Click, Display, and Social

Before you consider paid online advertising, you might want to use the techniques discussed above to develop your organic (non-paid) marketing foundation. When you have that foundation laid, paid advertising *can* help boost your business to the next level.

But paid advertising can turn very costly very quickly, without any guarantee that it will pay off in increased sales. A detailed discussion of paid online advertising is beyond the scope of this book, but I offer some basic information and resources recommended below.

In the most general terms, there are three main types of online ads to consider:

1. **Pay Per Click (PPC) search ads.** With PPC search ads, you'll set up an ad to appear in search results when users search for certain terms, like "local coffee roaster Alameda California" or "interior designer Chicago Illinois" or "online marketing consultant." In setting up the ad, you'll specify the keywords for which you want to appear in search results. You'll also specify other parameters like which cities, states, or countries you want to compete in for placement, and other demographic qualities of your target audience. You only pay when someone clicks on your search result; you can set limits so you don't exceed a certain amount per day. Google Ads is by far the biggest game in town for PPC search ads.
2. **PPC display ads, which are more like traditional visual ads, like banner ads or sidebar ads.** You pay for display ads similar to how you pay for PPC search ads—you're charged when someone clicks your ad—but the placement is different. Instead of appearing as a search engine result, the display ads are spread out over the internet, "pushed" to users, so to speak. Google Ads dominates PPC display ads as well.
3. **Paid boosts on social channels—sometimes called "sponsored" or "promoted" posts—are also a big part of the online ad world.** The concept is that you pay Facebook, Instagram or whatever social media channel to "boost" a post. You'll typically set up these sponsored posts by specifying the characteristics of the audience you want to reach based on location, interests and other demographic data.



RESOURCE

Recommended reading on PPC and online display ads. The online ad industry has no shortage of content about strategies, approaches and tools. Here are a few reputable sources of info.

- SEM Rush is a paid service for deep keyword analysis and other SEO-focused data. Its blog has exceptionally helpful info. See www.semrush.com/blog
- Search Engine Journal publishes an e-book with a good amount of depth and detail, *PPC 101: A Complete Guide to PPC Marketing Basics*. See www.searchenginejournal.com/ppc-guide
- WordStream offers a free, comprehensive resource, PPC University. Check it out at www.wordstream.com/learn

Forums and Listservs

Many business owners establish their expertise and spread the word about their

businesses by posting comments and engaging in threads in forums, Facebook groups, and other discussion areas online about topics related to their businesses. The key is to share information as an expert, not hustle for business. Including your business name and contact info may be okay, depending on the customs of the forum; actively soliciting business is generally a no-no.

If discussion groups exist about your business area, start there. If you can't find any, you could start a forum at your own website or create a Facebook group—but keep in mind that building even a small online community and moderating it will require a considerable time investment.

A listserv is similar to an email list, in that people who have signed up for the listserv receive emails. However, with a listserv, the emails can be sent by anyone who is part of the listserv, not just by the manager of the listserv. For example, someone who reads a listserv email could respond to the whole group by sending an email to the listserv, which would be distributed to all recipients of the listserv. In contrast, email lists are one-directional, from the business to the list.

Listservs are most common in nonprofit organizations and schools, but some businesses also have customers who want to engage in an ongoing email discussion group. Business listservs tend to be appropriate only when a business's customer base has a compelling desire to interact, such as with software companies whose customers like to share user tips with each other. Yes, listservs are pretty old-school, but if your industry has an established one, it could be a very powerful place to have a presence.

Back to Your Website: Options for Building a Site

We discuss the role a website can play in your online marketing efforts. In this section, we'll talk about different approaches to building a site, namely using a do-it-yourself (DIY) website platform versus hiring a web developer. We also discuss an alternative to having your own website—an affiliate store on a site like Etsy, Amazon, or eBay.

Using DIY Website Platforms

DIY website platforms like Wix, Squarespace, and Weebly offer user-friendly, cost-effective tools for building your own website. These tools are most appropriate if your site is relatively simple and doesn't need to plug into other systems (like a customer relationship management (CRM) system or e-commerce system), if you have basic technical skills, and if you can't afford the expense or time of a professionally

Monitoring Your Reputation Online

One of the downsides of social media is that people can complain about your business online—and when they do so, it's often done loudly and bitterly. So even if you don't have the resources to participate heavily in social media, you at least need to keep tabs on what others are saying about you online—good and bad.

Both online and off, people tend to voice complaints much more loudly than praise; it's just human nature. But online complaints are particularly problematic for businesses because they reach so many more people than just someone kvetching to their friends and social circles. Unfortunately, the reach of negative complaints means every business—whether it has much of an online presence or not—needs to be proactive about damage control and at least periodically check out what (if anything) is being said about it online.

If customers are likely to post reviews of your business on particular sites (for example, TripAdvisor for hotels and motels, or Yelp for restaurants), review those sites at least every month or so. Use Google to search for your business and any mention of it in blogs. Better yet, set up a Google Alert for your business name (and any other relevant terms, such as names of your main products, or your personal name); that way you'll get an email notification any time your business (or its products, services, employees, and so on) is mentioned online. Go to www.google.com/alerts to sign up for this free service.

If you do find instances of online customer complaints about your business, respond carefully and thoughtfully. First off, you don't need to respond to every minor complaint that you might read. Overreacting can make your business look desperate and petty. This is especially true if you have mostly positive reviews, with just a sprinkling of mildly negative comments. Potential customers are savvy enough to know that there will always be complainers, so if most online reviews are positive they'll likely believe the majority's opinion.

If, however, you find serious complaints, or a large number of them, you should consider responding on the site. Don't just give an empty apology; look into the problem before you respond and take whatever action is appropriate. Then respond with a brief apology and explanation of how you remedied the situation. In particularly egregious circumstances you might even want to offer that user some sort of a refund, either in the public forum or in a private email. The bottom line is to take your customer relations seriously and respond in a way that shows the customer—and the rest of the world reading that thread—that you truly want to make the situation right.

developed site. Most of these DIY platforms offer free trials so you can try before you buy. If you're interested in using a DIY builder, we suggest testing out a few so that you get a feel for their capabilities and limitations, including how they line up with your own technical skills. Most of all, make sure that the kind of site you can produce with a DIY builder meets the needs of your business. If not, consult with a professional web developer.

Fees for some DIY platforms can be as low as $5 per month or even free, but these lowest-end fees don't usually offer much in the way of features or support. Business sites can usually expect to pay $25 per month and up.

Using a DIY template site can take more time, effort, and skill than you might think. These services claim that even the least computer-savvy user can easily build a site, but that's not always the case. Inexperienced users might need to spend a fair amount of time learning the site-building system, often through trial and error, before being able to get a site up and running. When considering a web builder service, be sure to look for user comments (often at websites separate from the builder service) to get a sense of how easy or difficult they found the service to use.

Using a DIY template doesn't ensure that your site will be designed to meet the specific needs of your business. Deciding what content to include and how to break up and organize that content at the site can be more complicated than you think. Again, test the various DIY services to see what you're able to produce with them.

Using a Professional Web Developer

If your website is critical to your business, whether for marketing, e-commerce, or both, and if it requires more than you think you can give it using a DIY web builder, consider hiring a web development firm for your site. A website development project is a significant undertaking and investment: Expect to spend at least $3,000-$5,000 for a basic site, and more for advanced functions like e-commerce, online registration, and more. To help you plan and manage such a project, we've included a special supplement, "Working With a Web Developer to Create a Custom Site," on the companion page for this book on the Nolo website. See the Appendix for the link.

Opening an Affiliate Store: Amazon, eBay, Etsy, and Others

As an alternative to having your own website, you can open a store within an existing e-commerce site, such as Amazon, Etsy, or eBay. Creating a store within one of these mega e-commerce portals is definitely a quicker, easier, and less expensive way to get started selling your products online.

Typically, the registration and set up processes are easy to complete; as long as you have good photos of and copy about your products, you can be up and running in a day or two.

Having a store at Amazon or eBay and not your own website has its downsides, however. The main drawback could best be described as getting lost within the shopping mall. Instead of developing name recognition for your business and its domain name, customers will have to find you among the thousands and thousands of other Amazon or eBay sellers. Anyone who has shopped at Amazon and other similar e-commerce sites can testify that finding a store or product can be like finding a needle in a haystack. Even if you give your store a name, shoppers within sites like Amazon are much less likely to remember your store name than if you had a custom-built store with its own domain name and the ability to use the site design and content to develop your brand more strongly.

Another aspect to consider is that having a store within a big e-commerce operation restricts the content, design, and functions you can offer—and, by extension, your ability to control and develop your brand image. With your own site built by a developer, you can use design elements to reinforce your brand, and develop creative content to draw traffic—say, with a blog, an interactive customer service area, or other unique content. While stores within Amazon, Etsy, eBay, and others do allow you to offer some customized design and content, you'll be much more limited. Bear in mind that you can avoid this issue by having an affiliate store in addition to your own website that you use to develop your brand.

Driving Traffic to Your Site

You can market your site and drive traffic to it in a number of ways. The extent of your website marketing activities will depend on how your website fits into your overall marketing strategy. If you're planning an e-commerce site that will be the sole source of sales and income for your business, marketing your site will be critical. If, on the other hand, your website is a basic marketing site that isn't a significant source of referrals and doesn't play a major role in marketing your business, don't worry too much about actively promoting it. That said, all businesses should do simple things such as including their website URL on their business cards, flyers, any ads they run, and other materials they produce.

Developing Content and an SEO Strategy

Start by thinking about how people search for products or services: They type a query into a search engine. If the search engine "knows" about you and respects you,

your site will appear on the list of results, hopefully at the top. You could have the prettiest website around, but if it doesn't appeal to the search engines, no one will find it unless they happen to search for your business by name (or they scroll through pages of results until they see you).

When developing your content, you'll want to increase the chances that your site is respected by search engines and "ranks" high up in a search engine result page. Trying to improve your site's search engine results rank is called search engine optimization, or SEO. While SEO is a complex and constantly evolving topic, you can use a few basic strategies to boost your site's rankings. In a nutshell, your content affords you two simple SEO opportunities:

- **Developing inbound links.** Quality content that results in other sites' linking to your site ("inbound linking") does more than just boost site traffic. Having many inbound links will have a strong effect on how well your site ranks with search engines.
- **Relevant keywords.** Content that contains appropriate words and phrases will also improve your search engine results.

Let's discuss each of these in a bit more detail.

Inbound Links

Having a lot of inbound links is sometimes called "link popularity." Search engines have developed complex formulas to determine how many inbound links a site has, and, all things being equal, sites that have more inbound links will rank higher than other sites. The thinking goes, if other reputable sites find the content at a website useful, that is a powerful indicator that the site is a quality one that deserves to rank highly for relevant searches.

How does inbound linking relate to site content? Sites with quality content tend to have more inbound links than sites with meager or inferior content. For example, consider two websites, each of which sells tennis equipment. One is a straightforward e-commerce site that sells tennis rackets, shoes, tennis balls, and other equipment. The second site sells similar equipment, but also has informative how-to articles and a few streaming videos showing techniques, such as a primer on serving and a demonstration of different backhand techniques. Hundreds of other tennis-and sport-related websites link to the second, content-rich site for its informative content, while far fewer link to the first e-commerce site. So, when people search for "tennis," "rackets," or make other tennis-related searches, the second site ranks way above the first site in Google's search engine results.

As you can see, quality content has a doubly powerful effect on bringing traffic to your site: Besides merely attracting more visitors by virtue of being useful or compelling, content that many other sites have linked to will also raise a site's visibility by helping to improve its search engine rankings.

To attract links (and plain old traffic) to your site, include content that is useful, entertaining, or otherwise interesting to your target audience. Blogs that allow user comments can be very effective at drawing traffic. How-to articles are always popular, as are lists such as "Top Ten Ways to Make Your Home Greener," or "Five Tips to Improve Your Forehand."



TIP

Search engines consider the quality, not just the quantity, of the inbound links on your website. To favorably influence your search engine rankings, the inbound links must come from other reputable sites—not from shady sites such as "link farms," which are meaningless webpages with hundreds or thousands of links created by unethical web marketing firms trying to trick search engines. Quality inbound links are from legitimate sites like online publications, trade associations, or other businesses in related industries.

Keywords

When creating content, you'll also want to use certain words and phrases—called keywords—that potential customers are likely to use when searching for your site. To a search engine, a keyword is like a flag, telling the engine that the article or site has information about this term or word. Including appropriate keywords in your site content should help improve its search engine rankings.

When choosing keywords, put yourself in the mind of potential customers: What words and phrases would they use when searching online for a business such as yours? For example, if you own an electronics store selling audio and video equipment, typical keywords (which should include single words and multiple-word phrases) might include: audio, video, home audio, home video, home entertainment, stereo, surround sound, CD player, MP3 player, speakers, DVD player, DVR, television, TV, plasma TV, LCD TV, flat-screen TV.

The trick is to identify appropriate keywords, then use them in your site content so that they read naturally. Don't create awkward text that is crammed with keywords; site visitors (and sophisticated search engines) can usually see through this tactic or at the very least will be turned off by your poorly written copy.

Besides looking for keywords in your site's content, search engines also look at the page titles for relevant keywords. The title is what appears in the top bar of the browser window. Title text is set in the HTML code for a webpage; assuming you're hiring a web developer to create your site, the developer will know how to set the page title text. A developer who has expertise in search engine optimization can be a big help in choosing keywords and drafting title text; otherwise it's fairly simple for you as the business owner to do it.

Page titles should generally not be much longer than 80 characters, so include your most important, strategic keywords here. Ideally, you'll have custom keywords for each individual page. For example, instead of having the same title for every page of your plumbing supply e-commerce website, each page's title should accurately describe what's on the page. The home page title could be "McGee's Plumbing Supply—Clawfoot Faucets, Restoration Hardware, Vintage Accessories," while the title on the Faucets category page could be, "Clawfoot Faucets: Wall Mount, Tub Mount, Gooseneck; Hand Showers; Bronze, Chrome, Brass." Again, put yourself in the mind of your potential customers and think of words or phrases they would use when looking for your products or services.

Using Social Media to Drive Traffic to Your Site

Using social media channels like Facebook, X, or YouTube can be a great way to drive traffic to your site. The key is to use the channels that are frequented by your customers and potential customers, and to engage with them via entertaining or helpful content. Remember, being too self-promotional on social media can backfire, so proceed cautiously to ensure that your substance and tone are appropriate.



CAUTION

Social media platforms can be problematic. Evidence continues to mount revealing unethical practices such as privacy violations, turning a blind eye to misinformation, and outright fraud in reporting data to advertisers. Facebook (which owns Instagram and WhatsApp) has been a notable offender, but other platforms have been implicated as well. However, the reality for many business owners is that abstaining from these social channels weakens their promotional reach. You'll have to decide for yourself what you're willing to accept when deciding which social channels to use in promoting your business. One option is to use the channels only "organically," without paying for any sponsored posts. This, too, will reduce your reach, but it may be a better option than not having a presence at all on the platform.

Facebook is an important channel for many businesses and offers some great opportunities to connect with your audience and steer them to your site. Facebook has some frustrating practices, such as requiring payment to boost the visibility of your page and its posts. Users are largely at the mercy of Facebook as to these and other rules or algorithms that often change without notice. But, if you hold your nose and dive in, you might find that Facebook can really help your site's traffic.

Interactions on Facebook tend to be quick, casual, and informal, so it's generally fairly easy to maintain a page—usually considerably easier than maintaining your own blog, for instance. Include the URL for your main business website in the "Info" area of your Facebook page, and include links to it in your posts when appropriate; this will allow Facebook friends of your business to click through to your main site, where you'll likely have much fuller information about your business's products and/or services.

Similarly, creating an X, Instagram, YouTube, or other social media account for your business opens opportunities to get your brand noticed and steer traffic towards your site. As always, focus on the channels that your audience tends to use. Be thoughtful and strategic before creating accounts. For example, don't create a YouTube channel if you're not sure you can actually produce at least a couple videos a month.

Other Traffic-Boosting Tips

Here are a few more ways to steer traffic to your site.

Write for other sites. If you have expertise in a certain area, find online publications that are looking for writers—you'd be surprised how many there are. You might not get paid for your writing but can usually get a link to your site. Remember that it's best to be brief when writing for websites, so you usually won't need to write much more than 500 words, often less.

Submit press releases to online newswires. Sending press releases to local reporters and editors is a great way to get exposure for your business. On the web, you can submit press releases to distribution services such as PRWeb (www.prweb.com) or ResponseSource (pressreleases.responsesource.com), which (for a fee) can get your release picked up by Google News and Yahoo! News, as well as hundreds of other news outlets. When your press release includes one or more links back to your website, you can reap quality inbound links (because they're coming from a respected news site).

List your business in online directories. Loads of directories online are grouped by industry type, location, or other criteria. As long as the directories are fairly reputable and not link farms (see "Social media platforms can be problematic," above), being listed in them can be a great way to develop inbound links. Some directories charge fees, so do some research before deciding where to list. Pick the ones that are respected, look like they get the most traffic, and fit into your budget.

Join membership organizations that provide an online directory listing. Some organizations like your local chamber of commerce or other trade organizations will list your business in their online and print directories as a benefit of membership. Again, evaluate the membership fees and estimated distribution of the directories before deciding on which ones to join:

- **Search Engine Watch** (www.searchenginewatch.com) is a comprehensive site with the latest news on SEO strategies and techniques, and a huge archive of articles on search engine-related topics.
- **Keyword Discovery** (www.keyworddiscovery.com) and **Wordtracker** (www.wordtracker.com) are well-regarded subscription-based keyword research tools that offer sophisticated tools for choosing keywords and analyzing site traffic.
- **The SEO for Growth blog** (https://seoforgrowth.com/blog) by leading online marketing experts John Jantsch and Phil Singleton offers practical, detailed, and up-to-date posts full of winning SEO tips and strategies.
- ***SEO 2020: Learn Search Engine Optimization With Smart Internet Marketing Strategies,*** by Adam Clarke, is an accessible guide, written by a Google Analytics and Google Adwords certified professional.

Entrepreneur's Insight

Clare Zurawski, Grants Specialist and Management Advisor, New Mexico Community Capital Albuquerque regional manager of WESST, a New Mexico nonprofit dedicated to helping people start or grow their own businesses (www.wesst.org)

Although there are aspects of search marketing that do involve meticulous technical details, in general, SEO strategy is coming full circle to align with good old-fashioned target marketing and public relations. There are no shortcuts anymore. Essentially, an optimized website must contain relevant content that's well presented in the eyes of your customers.

E-Commerce: What's Involved?

Selling products or services online adds complexity and cost to your website. From a technical standpoint, your site will need to install shopping cart software that, at a minimum, handles the shopper's selections and checkout. Some shopping cart software does much more, such as providing discount codes, creating custom product categories, and managing inventory.

Besides shopping cart software, an e-commerce operation generally requires that your business have a merchant account, which is essentially a business bank account set up to accept credit and debit card payments. It's the same thing that a brick-and-mortar business needs to have in order to accept credit cards.

An e-commerce site also needs something called a payment gateway, which is the service that securely processes the transfer of money from the buyer's payment instrument to the seller's merchant account. Think of the payment gateway as analogous to the credit card swipe machine that's used in brick-and-mortar businesses.

Note that some services like PayPal and Stripe combine the functions of merchant accounts and payment gateways. More on this below.

Each of these services charges its own fees. Fees can include an application fee; annual or monthly fees (or both); and per-transaction fees, which may be a set amount or a percentage of the transaction total. Given the large number of shopping carts, merchant accounts, and payment gateway services available, and the complicated mix of fees they charge, picking the best suite of services for your e-commerce can be confusing, to say the least.

The good news is that a few standout e-commerce services have become well established. Services like PayPal, Stripe, Squarespace, and Google Checkout are particularly popular, as they offer bundled services, including shopping carts, merchant accounts, and payment gateways. Each of these services offers a variety of options, but they simplify the process for customers by offering a streamlined, integrated suite of components rather than forcing you to research and choose them on your own.

If you don't use a bundled service, you'll need to choose shopping cart software (popular carts include Adobe Commerce, WooCommerce, and Zen Cart), set up a merchant account (it's not a bad idea to start by inquiring with your existing business bank), and choose a payment gateway (Authorize.Net is a well-established and popular choice). Your shopping cart software, merchant account, and payment gateway need to be compatible with each other and with other technology used at your website, such as a content management system (like WordPress or Expression Engine). If you're working with a web developer, ask for recommendations, and ask other business owners for their experience with various service providers. If you are interested in setting up an online store with Amazon, eBay, or Etsy, see the discussion just above.

Domain Names and Hosting

Before your new website can go live, you must register a domain name and sign up with a web hosting company. Your domain

name is part of the address visitors will use to access your site, such as nolo.com or pbrainmedia.com. Your web host is the company that keeps your site pages on computer servers that are connected to the internet 24 hours a day, so the pages are always available for visitors to view.

Choosing and Registering a Domain Name

Your first task is to choose an available domain name—that is, a name that is not currently registered to, or being used by, another group. (See "Choosing a Domain Name," in Chapter 2.)

Your domain name has tremendous potential marketing value, so take the time to choose it carefully. It might not be just your business name that attracts customers; names of your popular products and services are also good candidates for domain names. Considering how inexpensive domain name registration is—roughly $10 per year—it makes little sense not to register multiple names if they are appropriate for your business.

It also often makes sense to register your domain name in multiple domains (in addition to .com) in order to establish the widest presence possible for your domain name. Beyond the most common.com domain, the .biz and .net domains are appropriate for for-profit businesses. However, don't make the mistake of registering a .org address for a for-profit business. The .org domain is intended for nonprofit organizations only. Even though this rule is not enforced by the .org registry, it's misleading and inappropriate to use a .org address for your for-profit business. At the very least, using a .org address will make your business look ignorant of domain name rules; at worst, customers will think you are trying to mislead them into believing you are a nonprofit.

Once you select an available name, register it online at one of the hundreds of domain name registrars.

If you'd like to do some comparison shopping, you can find a list of approved registrars at www.internic.net. One popular registrar is Namecheap at www.namecheap.com. At the Namecheap website, you will enter your proposed domain name to see if it has already been registered. If not, you can proceed and register the name yourself. Registration fees vary depending on the options you choose; all are generally affordable. Registering one name for one year through Namecheap costs under $10. Once you've chosen your options, simply enter information about your business and provide credit card information.

Although registering a domain name is pretty simple, beware of a serious potential problem: If you allow your web host to take care of domain name registration or renewal—a common practice—you must make sure it lists your business or an

authorized representative as the domain name registrant and administrative contact, not the host company's name. If anyone but you or an authorized representative of your business is listed as the domain name registrant, you might find that your control over your domain name will be seriously compromised. For example, you might not be able to make changes to your host account or even your domain name account. In this way, the web host company can hold your domain name hostage, preventing you from switching hosts or otherwise managing this crucial part of your business's identity.

Be particularly careful about the people who will have access to your website:

- **Registrant.** The registrant is the legal owner of the domain name. Use your business's legal name, not your web host company's name.
- **Administrative contact.** The administrative contact should be someone in your business who has authority to make policy decisions, particularly with regard to the domain name. Again, you should not list your web host company here.
- **Technical contact.** This is the person the registrar may contact with technical issues. You can list your web host company here.

If your web host handles domain name registration or renewal, make sure it uses the names you want. Otherwise, it could cost you many times the original registration fee to get the registration back in your rightful name.

Choosing a Web Host

A web host is a company that maintains servers, which are simply high-performance computers that are connected to the internet continuously. When your website files have been uploaded to the host's server and your web host has configured your domain name correctly, your website will be live and all the information it offers will be available to visitors around the globe, 24 hours a day, 365 days a year.

To choose from the many web hosts out there, get recommendations from other business owners to find one that offers reliable servers and good customer service. Look for reasonable customer service hours during which you can talk to an actual human. More than a few host companies offer no live-person customer service, which can be infuriating if you're experiencing any problems.

Web hosts charge by the month or by the year. Fees are based on how much data you need the server to store—that is, the disk space your files will occupy—or how much data you transfer to and from your website each month. A host that I use regularly, Siteground (www.siteground.com), starts at about $15 per month for small, basic sites.

Intellectual Property: Who Owns Your Website?

Intellectual property laws establish ownership rights and other rules for various types of works, such as text and artwork protected by copyright, marks used in business protected by trademark, and inventions protected by patents.

Copyright is of particular importance in web development projects, as many of the components of websites are protected by copyright. (It is also a huge issue on social media, where most people don't think twice before sharing creative works owned by someone else. See below for details on avoiding trouble on social media.)

Copyrightable materials include text, photos, artwork, and designs, as well as technology developed for your site, such as databases and programming. As you can imagine, serious troubles can arise if ownership of any aspect of your website is in dispute. The way to avoid this is by including clear copyright terms in your contract with the web developer. This section gives a quick overview of copyright basics and the issues that arise in web development projects.



RESOURCE

In-depth resources on copyright and intellectual property issues. For the full treatment on copyright and the permissions process, see *Getting Permission: Using & Licensing Copyright-Protected Materials Online & Off,* by Richard Stim (Nolo). For lots of free articles on intellectual property, see the "Patent, Copyright & Trademark" section of Nolo.com.

Copyright Basics

When someone owns copyright to certain works, it means that others may not reproduce, modify, distribute, or sell the works without the copyright owner's permission. Permission to use someone else's copyrighted content is known as a license. When you license content, you do not own it; you simply obtain the right to use it in specific circumstances. In contrast, buying the copyrights to a creative work, known as an assignment, gives you all the rights to the work as if you were the original copyright owner.

The general rule is that the person who creates content owns the copyright. However, if the work qualifies as a "work for hire," then the hiring party, not the creator, legally owns the copyright to it.

The rules regarding what constitutes a work for hire vary, depending on whether the work was created by an employee or an independent contractor.

Rules for Employees

When an employee creates any work in the course of employment, the work is considered a work for hire, so that the employer—not the employee—owns the copyright to that work. Having your website created by employees, not contractors, is the simplest and most straightforward way for your business to make sure that it owns copyright in all aspects of the site.

Unfortunately, having an employee create the website isn't an option for many start-up businesses. But fortunately, you can make the work a work for hire in other ways, even when it is created by an independent contractor, not an employee.

Rules for Independent Contractors

When an independent contractor creates certain types of content, the hiring party owns the copyright in the work if the contractor and hiring party have agreed in writing that the work is a work for hire. The written agreement is essential: Work-for-hire agreements are necessary whenever a nonemployee creates the work. Without a written work-for-hire agreement, nonemployee web developers owns copyright to the materials they develop for the website.

But there's an important wrinkle: You cannot turn every kind of creative work into a work for hire using a written agreement. According to copyright law, a work-for-hire agreement will give copyright to the hiring party only if the content is:

- part of a larger literary work, such as an article in a magazine or a poem or story in an anthology
- part of a motion picture or other audiovisual work, such as a screenplay
- a translation
- a supplementary work, such as an afterword, introduction, chart, editorial note, bibliography, appendix, or index
- a compilation
- an instructional text
- a test or answer material for a test, or
- an atlas.

Without trying to puzzle through how on earth lawyers came up with these categories, try to understand that depending on whom you ask, the categories might not include the components of websites. This naturally raises the question: If website materials cannot be the subject of work-for-hire agreements, how can you obtain ownership from a web development contractor? The answer is that you'll need to have a written and signed copyright assignment—an outright sale of all copyright from the contractor to your business. Though it's possible that website materials might legally fall into one of the work-for-hire categories, the safest route is to

assume they do not, and to handle ownership transfer with a copyright assignment.

To sum up, to obtain ownership of materials created by a web developer for your website, you'll need to:

- hire the creator as an employee—which usually is not a practical option, unless you already planned to hire a web developer on staff, or
- have a written copyright assignment, signed by both you and the developer, usually within your website development contract.

Employee or Independent Contractor?

The rules regarding how to correctly classify a worker as an employee or an independent contractor have lots of gray areas. In addition, state laws in recent years have established new rules as "gig economy" businesses battle to minimize their responsibilities as employers, and try to classify workers as contractors. See "Employees Versus Independent Contractors," in Chapter 16 for more details and an update on recent legislation regarding worker classification.

Protecting Your Interests

It's obviously in your interest to own all aspects of your website, so that you have the legal right to do anything you want with the site. For example, if you fail to obtain a copyright to the site's text content that was written by the web developer, the developer could potentially prevent you from making any changes to the text on the site. The same is true for images, graphic designs, and technologies created by the developer for the website. This scenario might sound far-fetched to you now, but consider what could happen if you and the developer ever got into a conflict and decided to part ways. A developer with a bone to pick who owns rights to your site could deal a serious blow to your online business.

Be aware that sometimes a web developer will not want to assign copyright ownership to your company for certain aspects of the site. As discussed below, this stance might be perfectly legitimate. What's crucial in this situation is for you to get permission—legally, a license—from the web developer to use their copyrighted work as necessary.

Without such permission, you'll be at the mercy of your web developer when you want to edit content or make changes to technology owned by the developer—a situation you definitely want to avoid.

A web developer might want to retain ownership in a number of situations. Developers sometimes create customizations to content management systems, shopping carts, or other functions. Because this technology is useful for multiple clients, developers are naturally not willing to transfer ownership of the programming

code to your company. Instead, they'll give your business permission, or a license, to use the technology in specified ways. Licensing is perfectly legitimate, but you'll need to be careful about a couple of things:

- **You need to protect your company's ability to make changes to the site down the road.** Always think about—and ask prospective developers about—what will happen if you end your relationship with the developer after the work is done. If the developer creates the site with proprietary technology (technology it owns), you could find it difficult or impossible to make changes without using the original developer. It's not uncommon for a business to learn this lesson the hard way and have to create a new website from scratch after ending its relationship with a previous developer, who refused to give the business permission to make changes to the code the developer owned.
- **If you are hiring the developer to create functions or other programming code that will give your business a competitive edge online, you'll want to obtain full ownership of that code so that it can't be used for other businesses.** Small, basic websites that simply want to establish an online presence usually don't need full ownership. But if you are paying a developer to create an innovative shopping cart customization or search function that will help distinguish you from your online competition, it's essential that you own that code when it's complete, so that it can't be used by anyone else without your permission (and possible licensing fees paid to you). Don't be surprised to be charged a premium for a full transfer of rights.

At the end of the day, the important thing is that you and the developer are on the same page about who owns what. Consider another possible scenario: Say your business has only a tiny budget for photographs for the site, and cannot afford the rates a developer would charge to take photos and transfer all rights to your company. As an alternative, your website development contract could specify that the developer will retain all rights to any photos it takes for the site, and that the developer grants your company a license (permission) to post the photos at the site indefinitely. In this case, your contract should state specifically how you are allowed to use the photos—and you must abide by the license agreement. With an agreement like this, you typically will not be allowed to use the photos in advertisements, on T-shirts, or in any other ways. As long as having broad use of the photos isn't important to you, letting the developer retain copyright is a good way to keep your website project costs down.

EXAMPLE: Marina is negotiating contract terms with the web developer she chose to create her pottery store's website. To keep costs down, Marina and the developer agree that Marina will be responsible for taking photos. However, they also agree that the developer may take photos for the site, and that he will retain the copyright to those photographs. To make sure she retains control over the website, Marina gets a provision in the contract granting her business a license to display any of the developer's photos at her website indefinitely. In addition, Marina asks the developer if he would be willing to include a license allowing her to modify the size and the brightness of the photos in case they need such adjustments. The developer agrees to a license to modify that is limited to size and brightness, but no other modifications.

In deciding which ownership or licensing arrangements will work for your business, keep in mind the following rule: The more important content or technology is to your site, the more crucial it is that you get either ownership or a broad license to use and possibly modify those materials. This is true whether or not the web developer has a valid reason to retain ownership. If it's essential that you own copyright ownership in a database or other technology, don't enter into an agreement that won't confer the rights you need.

Avoiding Copyright Troubles on Social Media

Copyright rules also extend to using content on social media. In an age of fast and furious sharing of photos, videos, quotes, and more, there's no question that copyright rules are often completely ignored or forgotten. Many people who would never dream of using someone else's photograph on their website without permission would share it on Facebook without a second thought.

Of course, it's undeniable that the customs of Facebook and X encourage a sharing mentality, and that this is often okay with owners of copyrightable material. For example, when someone creates a funny meme (a clever photo or video with text, meant to go viral), by posting it in the first place, it's clear they want it to be shared without an expectation of payment or credit to the creator. Note that some memes include a URL or another type of watermark on the image, making it clear the online creator wants that credit information to be included with the image. Removing the URL or watermark violates the clear intention of the creator, yet the likelihood of consequences is low. The bottom line is that on social media, while rules might seem fuzzier, the intention of the creator is an important consideration.

Using photos (or text, or anything subject to IP protection) that you find online and sharing them in any of your business's activities is a very bad idea if you don't have permission. It's one thing when an individual shares things recklessly, but when a business does it, the business is

attempting to profit commercially, making the transgression more egregious. Don't—as in, *do not*—feel free to use photos you find on Instagram or other social media unless you use them within the rules. If the photo does not include special licensing terms, then general copyright rules apply. Sometimes photographers include generous licensing terms within the information about the photo, such as giving permission to use it for noncommercial (or even sometimes commercial) uses, as long as credit is provided.

Other issues that can arise include using photos (or other copyrightable material) on social media that you paid a contractor for, but for a different use. Say, for example, you hired a photographer for photos of your café's food for its menu. Your contract with the photographer specified the photos were for the menu, but did not address social media use. If you start posting those food photos on Instagram, the photographer might be peeved—and have a case for infringement.

Because the possible use of photos and other creative works on social media is so endless, and so potentially high profile, make it a point to be clear (in writing) with anyone you hire for creative work about whether and what social media uses are allowed. Many photographers would be happy for you to share their work on social media (assuming they've been paid), but often want to be credited. Giving credit is easy to do, and can actually help the reach of that social media post by potentially tapping into the photographer's followers.

On the flip side, be crystal clear: Giving credit does not get you out of infringement trouble if you're, in fact, using something without permission.

Chapter 14 Checklist: Digital Strategy: Selling and Marketing Online

- ☐ Assess your digital strategy and goals for your site and any other online activities, and how they fit into your overall business plan.
- ☐ Consider the wide range of ways your business can reach out to customers online, such as with a blog, email lists, e-newsletters, listservs, e-commerce, social media, and others, when crafting an e-business plan.
- ☐ Decide whether to use a DIY website builder or a professional web development firm for your site.
- ☐ When marketing your site using social media, make sure to avoid copyright infringement claims. Ask for permission before sharing anything that you or your business doesn't own.

CHAPTER 15

Planning for Changes in Ownership

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All business owners should think about and plan how to handle future changes in business ownership. It probably won't be top of mind in your start-up days, but, unfortunately, businesses commonly face situations that raise serious—and often unexpected—ownership questions. An incapacitating illness or untimely death are just two of the more extreme situations that call the business's ownership into question. What if an owner becomes incapacitated and can no longer participate in the business? Will a deceased owner's child inherit the ownership interest and become an active owner of the business? Plenty of other situations can have an impact on the ownership of the business.

Many circumstances, of course, can trigger a change in ownership. An owner retires from the business and wants to cash out their ownership interest. A dispute arises between owners and necessitates a buyout of one of the warring parties. An owner gets divorced, with their ownership share being marital property and subject to inclusion in a divorce settlement. When such circumstances occur, the interests of multiple parties—the company, the owner who is deceased, incapacitated, retiring, being pushed out, or divorced, and the remaining owners—need to be considered. In a small business with owners who are active in the business, changes in ownership can mean changes in the operation of the business, which can complicate matters. The best way to handle all these situations is to make an agreement about how the business will deal with them. This type of agreement is known as a buy-sell agreement; the phrase "buy-sell" refers to the rules it outlines for how a company's ownership shares may be bought or sold. By anticipating certain events and defining what will happen if they arise, a buy-sell agreement can lessen the chaos that ownership changes can inflict on a business.

Busy as you are with the details and concerns of starting up your business, it makes sense to address these issues even before you get up and running. Because buy-sell provisions generally limit what owners can and cannot do with their ownership interests, it's crucial to create fair, impartial rules while everyone is on equal footing. If you wait until something happens that puts ownership on the brink of change—for example, one owner becomes incapacitated and desperate to sell out—you'll have a much harder time imposing rules that are comfortable for everyone involved. And addressing buy-sell provisions early on is one of the best ways to build and maintain harmonious relationships among business co-owners. This chapter's sample buy-sell provisions will help you get started in drafting your own agreement (see this book's companion page for a full buy-sell agreement).



RESOURCE

For more in-depth information. While you'll learn the basic, essential elements of buy-sell agreements in this chapter, *Business Buyout Agreements: Plan Now for All Types of Business Transitions*, by Bethany Laurence and Anthony Mancuso (Nolo), covers much more ground. It walks you through the process of drafting a comprehensive buy-sell agreement that addresses a wide range of issues such as structuring and funding buyouts, and tax and estate planning concerns.

When You Need a Written Buy-Sell Agreement

If your business—whether partnership, LLC, or corporation—has more than one owner, you would be wise to have a written buy-sell agreement in place. (A single-owner business owner can plan for the business's succession through estate planning.) Rather than let ownership changes sneak up on you and wreak havoc on your company, it's much smarter to accept that ownership of the business will likely change at some point, and plan for that day. If you still need convincing, consider some common situations and how they can impact a business. If you still need convincing, consider some common situations and how they can impact a business.

An Owner Leaves or Retires

It's often said that being a co-owner of a business is like being in a marriage—and the pressures of running the business can lead to a bitter breakup. But even when co-owners get along famously, one of them might simply want to retire or do something different.

Whatever the circumstances, the potential departure of an owner raises serious questions. What if an owner decides to stop working for the company but refuses to sell the share in the business, hoping to earn income without contributing to it? Assuming an owner does plan to sell their interest in the business, can the sale be to anyone at all? Clearly, the remaining co-owners would not be happy to learn the departing owner sold to someone they all detest. How will the price of the departing owner's interest be determined if offered for sale? Valuing the company and determining share price can be quite contentious, particularly when continuing owners want to purchase the share.

On the flip side, consider what would happen if you wanted to retire. What if you couldn't find someone to buy your interest, and your co-owners didn't want or couldn't afford to buy your share? Would you be stuck, unable to cash out?

An Owner Becomes Disabled

If one owner has a debilitating stroke, is paralyzed in a car accident, or suffers some other incapacitating illness, the remaining owners face some big questions: Can they force the disabled owner to sell out? Can the departing owner sell to whomever he or she pleases? If the sale is to the continuing owners, what price must they pay for that share?

Again, the issues shift a bit for the person who becomes disabled and wants—or, more likely, needs—to sell. If you find yourself in this situation, you'd likely be concerned about being able to sell your ownership interest for cash to help pay medical bills and get through the tough time. Truth is, it's often difficult for small business owners to find outside buyers, especially for a minority ownership interest. If your co-owners are uninterested or unable to buy you out and you have no buy-sell agreement in place, you could find yourself in a really tight spot.

An Owner Dies

The death of a co-owner leaves the other owners to figure out who will own the deceased owner's share. For example, will they be forced to accept anyone who inherits the ownership interest as a new, active owner? What if the person who inherits the share wants to sell it for cash to the current owners, or to an outside buyer?

Similarly, if you die, these questions will be dropped into the minds of your grieving family members or the people who might take over your ownership share. They might need money for funeral expenses, not to mention living expenses once you aren't earning income.

An Owner Divorces

Roughly half of all marriages end in divorce, so you absolutely must deal with the question of how a marital split might affect your business.

The most glaring possibility is that when a co-owner gets divorced, the ex can become a new owner of the business. Except when a prenuptial agreement or "prenup" prevents it—and, in reality, many prenups are hard to enforce—spouses of business partners often have a legal interest in the business. This legal right is most clear in community property states—including Arizona, California, Idaho, Nevada, New Mexico, Texas, and Wisconsin—in which each spouse owns half of the couple's community property, usually most of the property gained during the marriage. (Couples in Alaska, South Dakota, and Tennessee can opt in to a community property approach.) But even in noncommunity property states, laws often require that a couple's property be divided fairly during divorce.

Having an ex suddenly on board can, of course, be a true disaster, especially if

former spouses each have an ownership share and must run the business together. Even if the original co-owner sells out of the business and the ex remains an owner, there's a huge potential for drama and trouble—particularly if the divorce was a nasty one. If the divorce was friendly, an ex who has no business experience or is just plain incompetent might still be unwelcome as an owner. In short, there are ample and compelling reasons to preemptively avoid these situations by implementing a sound buy-sell agreement.

To avoid these situations, all spouses of each current business owner should read and sign the buy-sell agreement.

An Owner Becomes a Liability

All businesses experience occasional squabbling and sniping, but in extreme cases, conflict crosses the line and some of the owners agree that it's time to push out one of the others. This situation can arise for all kinds of reasons: The owner may be inherently unreasonable and difficult, suffering from alcoholism or substance abuse, mentally ill, or engaged in criminal behavior.

Whatever the root cause, once things have deteriorated to an intolerable level, it's important to have a mechanism in place to expel an owner. Having rules—for instance, outlining the situations that call for expulsion—will help make this nasty situation a little less nasty.

Buy-Sell Agreement Basics

A buy-sell agreement is a contract among a business's owners that spells out, in varying degrees of detail, some or all of the following issues:

- who can buy a departing owner's interest
- when the owners can force another owner to sell a share of the business
- when one owner can force the other owners to buy a share
- what price will be paid for a departing owner's share, and
- how a buyout will actually happen, including specific payment terms.

In practice, buy-sell agreements use standard, or common, provisions to handle these issues. Buy-sell provisions can be either assembled into their own stand-alone agreement or inserted into other business documents, such as your partnership agreement, LLC operating agreement, or corporate bylaws. The term buy-sell agreement in this chapter includes any buy-sell provisions your company has adopted, whether they're in a separate agreement or included in another business document.

Let's look more closely at the core provisions in buy-sell provisions.

Limiting Ownership Transfers

When an owner wants to leave a business and sell an ownership interest, it can create real and lasting chaos if the share is sold to someone the other owners don't want as a co-owner.

The best way to avoid unwanted outsiders gaining ownership of your business is with a provision known as a "right of first refusal." This provision gives the company or the remaining co-owners the right to buy a departing owner's interest before it's transferred—that is, sold or given—to an outsider.

It works like this: A departing owner who receives an offer to purchase their interest from an outsider may not accept it outright. Instead, the right of first refusal requires the departing owner to give written notice to the company stating the intention to sell the shares and describing the terms of the proposed sale. At that point, the company and the continuing owners have the option to buy the departing owner's interest. Depending on how you structure your right of first refusal, the company and continuing owners will be entitled to purchase the shares either at the same price as the outsider offered or at a price previously agreed upon and included in the agreement. If the co-owners don't want to buy the ownership interest at those terms, then the departing owner has 60 days to sell it to the outsider according to the terms outlined in the notice.

You can also include solutions such as the following for dealing with related issues in the right of first refusal:

- **Extend the right to potential purchases to current owners.** When a departing owner offers a share to another current owner, all the co-owners must be given the option to buy it. The main reason to use this arrangement is to prevent one or more co-owners from seizing control of the business by buying a departing owner's share.
- **Create different rules for gifts or transfers to trusts.** It's possible to have the right of first refusal apply to sales of ownership shares, as described above, but not to other types of transfers, such as gifts or transfers to living trusts. Generally, giving ownership shares to family members or putting them in a trust is done for estate planning purposes—to save estate taxes and avoid probate. If you and your co-owners want more freedom to engage in estate planning techniques with your ownership shares, you might not want the right of first refusal provisions to apply to gifts and transfers to trusts.

- **Prohibit all transfers.** To keep the tightest grip on control of company ownership, the start-up owners can ban all ownership transfers outright. However, because this approach is so rigid and unhelpful to owners who might really need to sell out, it is generally not a good idea.

Forcing Buyouts

In addition to controlling who owns a business, an important function of a buy-sell agreement is to provide answers to the questions that can arise when the ownership setup is thrown into question. What if one of your co-owners dies? Will the heirs become co-owners in your business? What if a co-owner slides into crippling alcoholism or substance abuse? Will you be stuck with a mentally incapacitated business partner? What if your co-owner gets divorced and the dreaded ex-spouse gets an ownership share as part of the divorce settlement? Is there anything you can do?

You can remove the uncertainty from all of these situations by taking preventive action. By adopting forced buyout provisions in a buy-sell agreement, you'll establish rules for different scenarios, such as death, divorce, bankruptcy, retirement, and other business-disrupting events. When the rules are triggered by specific events, an owner can be forced to sell shares, or continuing owners can be forced to buy out a departing owner's share. Forced buyout rules help keep the business stable during difficult times and make ownership transitions as smooth as possible.

As you can imagine, a crucial fact about forced buyout provisions is that they must be agreed to well in advance of any situation that will trigger them. It goes without saying that the situations that trigger these provisions—such as death, disease, and divorce—often cause emotions to run high. You and your co-owners should discuss the possible scenarios and come to a consensus on the rules that will apply in those situations before an owner is personally affected.

In a nutshell, there are two different kinds of forced buyouts: Either an owner can be forced to sell out, or a departing owner can force the other owners to buy the departing owner's share.

Forcing Owners to Sell

Business owners can force an owner or other person who has obtained an interest in the business to sell out of it—and sell the shares back to the company or the continuing owners at a specified price. They do it by including an option-to-purchase provision in the buy-sell agreement.

This provision can force any of the following people to sell back to the continuing owners:

- any of the owners, for specified reasons such as retirement, disability, bankruptcy, loss of professional license, or misconduct
- the executor or administrator of a deceased owner's estate, and
- an owner's ex-spouse who gains an interest in the business through a divorce settlement.

The rules vary depending on the situation that triggers the forced buyout, but the overall goal is the same: to keep control over the company's ownership and keep out anyone unacceptable to the continuing owners. This includes people who stand to gain ownership through inheritance, divorce, or bankruptcy—as well as current owners whom other owners want to push out.

All options to purchase should also address the price at which the shares will be sold. Usually this is accomplished by referring to the "Agreement Price" outlined in a separate buy-sell provision. (Price provisions are discussed in "Establishing the Price for Sales: How to Value the Business," below.)

Forcing Owners to Buy

The flip side of an option-to-purchase provision is the right to force a sale. Without a right-to-force-a-sale provision, an owner who wants to sell out might be stuck if the current owners don't want—or don't have the funds—to purchase their share. But with a forced buyout provision, anyone with an ownership interest in the business can force the other owners to buy that interest at a specified price. Common scenarios include an owner who's retiring or becomes disabled, or a deceased owner's survivors who want to cash out the ownership interest they received as a bequest in a will or from a trust.

Beware that while a forced buyout provision protects owners from being stuck in a business, it also has the potential to seriously damage a company that doesn't have the means to pay out departing owners, particularly when the business isn't comfortably profitable.

But there is a way both to protect business owners who don't want to be chained to the business forever and to protect the business from bleeding money from cashing out owners. Your right-to-force-a-sale clause can allow owners to cash out of the business only after a certain time, by which you expect your business to be stable and profitable enough to pay out a departing owner. Anyone who chooses to cash out before that time—for example, three or five years—will receive only a fraction of the value of ownership share—say, 50%. This discount creates a

disincentive for any owner to leave early in the life of the business, when cash reserves might be crucial.

Negotiations can easily get tangled up on price issues, so it's important that the right to force a sale provision addresses the price at which the shares will be sold. Generally, it will refer to a separate pricing provision, which is discussed next.



CAUTION

Wrinkles for co-owners with unequal shares. If your company has one controlling owner and one or more owners with small minority shares, the controlling owner might not want to be subject to the same rules as the minority owners. For example, say a company has a majority owner who is very identified with the company and who has played the primary role in building it over many years. The majority owner might balk at the idea that the minority owners could force their children to sell their shares, elevating the minority owners to control the company. Majority owners should consider consulting an experienced business lawyer before signing a buy-sell agreement. Before doing that, it's a good idea to read *Business Buyout Agreements: Plan Now for All Types of Business Transitions*, by Bethany Laurence and Anthony Mancuso (Nolo), which explains the subtleties of buy-sell agreements in much greater detail than found this chapter.

Establishing the Price for Sales: How to Value the Business

In addition to spelling out ownership transfer rules for specific situations, a buy-sell agreement should outline how to set the price for shares being sold. It's all too common for departing and continuing owners to have significantly different ideas about a company's market value.

Without a clear, established system as to how to determine the company's value, negotiations can be stymied or sunk. This provision can also cover details of the ownership transfer, such as how it will be funded and payment terms.

A company's value includes its equipment, property, and accounts receivable, which are simple enough to total. But it's much harder to put a price tag on intangibles, such as business reputation or customer lists.

One approach to overall valuation is to establish a preset value for the company. Though the simplicity of this approach might be attractive, the obvious weakness is that the fixed price is likely to become outdated, particularly if the business is growing or shrinking rapidly. One way to remedy the problem of an unrealistic, stale valuation to update the fixed price periodically, say, every year.

A better approach is to use a valuation formula, which gives you a clearly defined way to figure out the value of the business and, by extension, the price of the ownership shares up for sale. The value generated by a formula will be more meaningful than a fixed value, because the formula will be based on current data such as current assets or income.

You can use one of several valuation formulas and methods. Here is a look at the most common ones.

Book Value

A company's book value is simply its assets minus its liabilities, the same as the information on a balance sheet. Because the figures used to calculate book value are readily available from various financial statements, this formula is easy to use and understand. Although book value does not include intangibles such as reputation, earnings potential, or customer goodwill, those elements might not be a big issue for a new business that hasn't had the time or luck to develop much of a reputation or goodwill. Another downside to this method is that it uses the depreciated value of assets, which typically results in a low value overall. As your business grows, it might be wise to switch to a valuation method that captures more of the business's value and provides a higher buyout price.

Multiple of Book Value

The "multiple of book value" method is based on the book value approach, but goes further and includes intangible assets such as customer goodwill, a solid client base, a desirable location, a recently implemented marketing campaign, and intellectual property owned by the business. The overall value is reached by taking the business's book value and multiplying it by a predetermined number, aptly called a multiplier. The co-owners choose a multiplier to include in the buy-sell agreement—and choosing is more of an art than a science. You'll find a wide range of multipliers used, from just over one to six or more. Do some research into your industry before choosing a multiplier. Googling "business value multiplier" and including your business type in the search terms is a good way to start.

Capitalization of Earnings

Also called "multiple of earnings," the capitalization of earnings method bases a company's value on its record of profits. Because brand-new businesses won't have a profit record, do not use this method until you develop an earnings history. The valuation begins with the company's annual profit (gross revenues minus costs) multiplied by a predetermined number—a

multiplier, sometimes called a capitalization rate. Co-owners choose a multiplier based on several factors, including general economic conditions, type of business, business age, risk involved in business, or multipliers of similar businesses. Multipliers for the capitalization of earnings method can go as high as ten.

Appraisal Value

Rather than doing the work yourselves, you can hire a professional business appraiser to determine a business's value once an ownership transfer is imminent. That certainly makes things easier for the co-owners, but it's not without drawbacks. One is cost: Appraisers don't come cheap. Expect to pay at least $1,000 for an appraisal of a small company, and up to $10,000 for large businesses with annual sales in the millions. Appraisals can also take valuable time, which could be an issue when an owner is eager to sell.

At the end of the day, you'll need to choose the valuation method that works best for your company. As a general rule, methods based on book value tend not to be good choices for service businesses that may have few assets. For such businesses, basing valuation on earnings history makes more sense.



TIP

Address other issues, such as payment terms and the funding source. Because ownership shares can involve big sums of money, buyouts cannot always be paid for all at once. It's a good idea to outline specific payment terms in your agreement—for instance, monthly payments of principal and interest, or some other arrangement. It's also wise to address where the money will come from in the case of a buyout. Businesses commonly need to take out a loan to pay departing owners, or use proceeds from life or disability insurance. If you don't plan in advance how you'll fund buyouts, you might find there's not enough time to scramble the money together once something triggers a buyout.

Implementing Buy-Sell Provisions

You can assemble your buy-sell provisions into their own document. Or you can add the provisions to your existing business-governing document (for corporations, this is the bylaws; for LLCs, it's the operating agreement; for partnerships, it's the partnership agreement). If you want to use the sample provisions provided below, insert them into your existing business-governing document, because the template includes only the basic clauses that won't, on their own, constitute a complete document.

To place clauses into the existing document that governs your business, insert the clauses into your document file, preferably near the end. Renumber the sections as needed to conform with the existing numbering of your document.

Note that many of the standard clauses in the sample agreement have multiple options with checkboxes. Feel free to either copy and paste all the possible options and use the checkboxes to indicate your choices, or copy and paste only the clauses you choose. It is not a good idea to select only parts of a clause; instead, choose among the clearly defined options.

Before finalizing your agreement, compare your agreement to your existing business documents to see whether any of the buy-sell provisions conflict with the terms in these documents. This comparison is known as a "consistency check." You might find, for example, that your LLC operating agreement states that any person who is at the receiving end of an ownership transfer will have economic rights only—as in, no voting rights or management authority. Your buy-sell provisions, on the other hand, are based on the assumption that full ownership rights will be transferred, including voting and management rights. This inconsistency should trigger alarm bells. You could delete the limited-ownership-rights provision from your existing operating agreement, or change the buy-sell provision.

Generally, if no clauses in your existing document explicitly contradict the buy-sell provisions, you might be in the clear. Still, analyzing the provisions for conflict can be confusing, and you might want to pay a lawyer to review the document and your buy-sell provisions, and bring one or the other document into line if they are not consistent.

Sample Buy-Sell Provisions

When drafting your own agreement, start with the sample buy-sell clauses below. The clauses are in the agreement that you can download from this book's companion page on Nolo.com.

The sample agreement begins with one basic provision that might be necessary in some states, where a partnership or LLC dissolves by law once an owner is "dissociated." In other words, dissolution results when an owner sells an interest, dies, withdraws, or otherwise no longer holds an ownership interest (unless the remaining owners vote to continue the business). To counter this rule, you'll need a statement, like the one in our provision, that the company does not terminate when an owner transfers an interest, dies, withdraws, files for bankruptcy, is expelled, or otherwise leaves the company. Perform a consistency check here, too, by making sure there is no statement to the contrary elsewhere in your partnership or operating agreement.

Sample Buy-Sell Agreement Provisions

Section 1: Introduction

The legal existence of the company shall not terminate upon the addition of a new owner or the transfer of an owner's interest under this agreement, or the death, withdrawal, bankruptcy, or expulsion of an owner.

Section 2: Limiting the Transfer of Ownership Interests

Right of First Refusal

(a) No owner ("transferring owner") shall have the right to sell, transfer, or dispose of any or all of an ownership interest, for consideration or otherwise, unless he or she delivers to the company written Notice of Intent to Transfer the interest stating the name and the address of the proposed transferee and the terms and conditions of the proposed transfer. Delivery of this notice shall be deemed an offer by the transferring owner to sell to the company and the continuing owners the interest proposed to be transferred.

If the proposed transfer is a sale of the owner's interest, these terms shall include the price to be paid for the interest by the proposed transferee, and a copy of the offer to purchase the interest on these terms, dated and signed by the proposed transferee, shall be attached to the notice.

(b) The company and the nontransferring owners then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase the interest proposed for transfer, and may do so within 60 days after the date on which the company receives notice or becomes aware of the event triggering the Option to Purchase.

If the company and the nontransferring owners do not elect to purchase all of the interest stated in the notice, the transferring owner may then transfer his or her interest to the proposed transferee stated in the notice within 60 days after the nontransferring owners' purchase option ends.

(c) Price and terms:
[*Check either Option 1a or Option 1b below.*]

☐ **Option 1a: Price and terms in offer**

The company and the nontransferring owners shall have the right to purchase the interest of the transferring owner only at the purchase price and payment terms stated in the Notice of Intent to Transfer submitted to the company by the transferring owner. The price and terms in this notice override the general Agreement Price selected in the "Agreement Price" and "Payment Terms" sections of this agreement.

☐ **Option 1b: Price and terms in agreement**

The company and the nontransferring owners shall have the right to purchase the interest of the transferring owner at the Agreement Price and payment terms selected in the "Agreement Price" and "Payment Terms" sections of this agreement.

Section 3: Providing the Right to Force Buyouts

Scenario 1. When an Active Owner Retires or Quits the Company's Employ

[*You may check Option 1, Option 2, both, or neither below. Check Option 1 if you want the company and continuing owners to have the option to buy a retiring owner's interest.*]

☐ **Option 1: Option of Company and Continuing Owners to Purchase a Retiring Owner's Interest**

An owner who voluntarily retires or quits the company's employ is deemed to have offered his or her ownership interest to the company and the continuing owners for sale. The company and the continuing owners shall then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase all or part of the ownership interest within 60 days after the date on which the company receives notice or becomes aware of the event triggering the Option to Purchase. The price to be paid, the manner of payments, and other terms of the purchase shall be according to the "Agreement Price" and "Payment Terms" sections of this agreement. An owner who stops working for the company is referred to as a "retiring owner" below.

[*Check Option 2 if you want a retiring owner to be able to force the company to buy his or her interest. This right can be in addition to Option 1 (company and continuing owners' option to purchase) above.*]

☐ **Option 2: Right of Retiring Owner to Force a Sale**

An owner who voluntarily retires or quits the company's employ can require the company and the continuing owners to buy all, but not less than all, of his or her ownership interest by delivering to the company at least 60 days before departing a notice of intention to force a sale ("Notice of Intent to Force a Sale"). The notice shall include the date of departure, the name and address of the owner, a description and amount of the owner's interest in the company, and a statement that the owner wishes to force a sale due to the owner's retirement as provided in this provision. The price to be paid, the manner of payments, and other terms of the purchase shall be according to this section and the "Agreement Price" and "Payment Terms" sections of this agreement. An owner who requests that an interest be purchased is referred to as a "retiring owner" below.

Scenario 2. When an Owner Becomes Disabled

[*You may check Option 1, Option 2, both, or neither below. Check Option 1 if you want the company and continuing owners to have the option to buy a disabled owner's interest. If you check Option 1, insert the amount of time an owner must be disabled before the company or the continuing owners can purchase the available interest.*]

☐ **Option 1: Option of Company and Continuing Owners to Purchase a Disabled Owner's Interest**

An owner who becomes permanently and totally disabled, and such disability lasts at least _____ months (the "waiting period"), either consecutively or cumulatively, is deemed to have offered his or her ownership interest to the company and the continuing owners for sale. The company and the continuing owners shall then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase all or part of the ownership interest within 60 days after the date on which the company receives notice or becomes aware of the event triggering the Option to Purchase. The price to be paid, the manner of payments, and other terms of the purchase shall be according to this section and the "Agreement Price" and "Payment Terms" sections of this agreement.

An owner who is unable to perform his or her regular duties is considered disabled. If disability insurance is used to fund a buyout under this provision, the insurance company shall establish whether an owner is disabled; without disability insurance, the owner's doctor will establish whether an owner is disabled. An owner who becomes disabled according to this section is referred to as a "disabled owner" below.

[*Check Option 2 if you want a disabled owner to be able to force the company to buy his or her interest. This right can be in addition to Option 1 (company and continuing owners' option to purchase) above. If you check Option 2, insert the amount of time an owner must be disabled before forcing the company to purchase an interest.*]

☐ **Option 2: Right of Disabled Owner to Force a Sale**

An owner who becomes permanently and totally disabled, and such disability lasts at least _____ months (the "waiting period"), either consecutively or cumulatively, can require the company and the continuing owners to buy all, but not less than all, of his or her ownership interest by delivering to the company, within 30 days of the expiration of the waiting period, a notice of intention to force a sale ("Notice of Intent to Force a Sale") in writing. The notice shall include the name and address of the owner, a description and amount of the owner's interest in the company, and a statement that the owner wishes to force a sale due to disability as provided in this provision. The price to be paid, the manner

of payments, and other terms of the purchase shall be according to this section and the "Agreement Price" and "Payment Terms" sections of this agreement.

An owner is who is unable to perform his or her regular duties is considered disabled. If disability insurance is used to fund a buyout under this provision, the insurance company shall establish whether an owner is disabled; without disability insurance, the owner's doctor will establish whether an owner is disabled. An owner who becomes disabled according to this section is referred to as a "disabled owner" below.

Scenario 3. When an Owner Dies

[*You may check Option 1, Option 2, both, or neither below. Check Option 1 if you want the company and continuing owners to have the right to buy a deceased owner's interest.*]

☐ **Option 1: Option of Company and Continuing Owners to Purchase a Deceased Owner's Interest**

An owner who dies and the executor or administrator of the estate or the trustee of a trust holding the ownership interest are deemed to have offered the deceased owner's interest to the company and the continuing owners for sale as of the date of the notice of death received orally or in writing by the company. The company and the continuing owners shall then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase all or part of the ownership interest within 60 days after the date on which the company receives notice or becomes aware of the death. The price to be paid, the manner of payments, and other terms of the purchase shall be according to the "Agreement Price" and "Payment Terms" sections of this agreement. An owner who has died is referred to as a "deceased owner" below.

[*Check Option 2 below if you want the estate, trust, or inheritors of a deceased owner to be able to force the company to buy his or her interest. This right can be in addition to Option 1 (company and continuing owners' right to purchase) above.*]

☐ **Option 2: Right of Estate, Trust, or Inheritors to Force a Sale**

When an owner dies, the executor or administrator of the deceased owner's estate, the trustee of a trust holding the deceased owner's ownership interest, or the deceased owner's inheritors can require the company and the continuing owners to buy all, but not less than all, of the deceased owner's interest by delivering to the company within 60 days a notice of intention to force a sale ("Notice of Intent to Force a Sale") in writing. The notice shall include the name and address of the deceased owner, the date of death, a description and amount of the owner's interest in the company, the name and address of the person exercising the right to force the sale, and a statement that this

person wishes to force a sale of the interest due to the owner's death as provided in this provision. The price to be paid, the manner of payments, and other terms of the purchase shall be according to the "Agreement Price" and "Payment Terms" sections of this agreement. An owner who has died is referred to as a "deceased owner" below.

Scenario 4. When an Owner's Interest Is Transferred to His or Her Former Spouse

[*Check Option 1 if you want the company and owners to have the right to buy a divorced owner's interest from his or her former spouse.*]

☐ **Option 1: Option of Company and Continuing Owners to Purchase Former Spouse's Interest**

(a) If, in connection with the divorce or dissolution of the marriage of an owner, a court issues a decree or order that transfers, confirms, or awards part or all of an ownership interest to a divorced owner's former spouse, the former spouse is deemed to have offered the newly acquired ownership interest to the divorced owner for purchase on the date of the court award or settlement, according to the terms of this agreement. If the divorced owner does not elect to make such purchase within 30 days of the date of the court award or settlement, the former spouse of the divorced owner is deemed to have offered the newly acquired ownership interest to the company and the co-owners (including the divorced owner) for purchase, according to the terms of this agreement. The divorced owner must send notice to the company, in writing, that his or her former spouse now owns an ownership interest in the company. The notice shall state the name and address of the owner, the name and address of the divorced owner's former spouse, a description and amount of the interest awarded to the former spouse, and the date of the court award. If the company does not receive notice from the divorced owner, an offer to the company and the co-owners is deemed to have occurred when the company actually receives notice orally or in writing of the court award or settlement transferring the divorced owner's interest to the owner's former spouse. The company and the co-owners (including the divorced owner) shall then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase all or part of the ownership interest within 60 days after the date on which the company receives notice or becomes aware of the event triggering the Option to Purchase. The price to be paid, the manner of payments, and other terms of the purchase shall be according to the "Agreement Price" and "Payment Terms" sections of this agreement.

(b) A former spouse who sells an ownership interest back to the company or continuing owners agrees to be responsible for any taxes owed on those sales proceeds.

Scenario 5. Expulsion of Owner

[*Check Option 1 below if you want to give the company and the continuing owners the option to purchase an expelled owner's interest. If you check Option 1, also check and fill in Options 1a through 1f.*]

☐ **Option 1: Option of Company and Continuing Owners to Purchase an Expelled Owner's Interest**

(a) When the company has three or more owners, situations may arise in which a group of owners wishes to expel another owner. An owner may be expelled upon a unanimous vote of all other owners for adequate cause. Upon such expulsion, the expelled owner is deemed to have offered to sell all of his or her interest to the company and the continuing owners. The company and the continuing owners shall then have an option, but not an obligation (unless otherwise stated in this agreement), to purchase all or part of the ownership interest within 30 days after the vote to expel the owner. The price to be paid shall be as specified in this section; if not so specified, then according to the "Agreement Price" section of this agreement. The manner of payments and other terms of the purchase shall be according to the "Payment Terms" section of this agreement. An owner who has been expelled is referred to as an "expelled owner" below.

(b) Adequate cause includes, but is not limited to:

☐ **Option 1a: Any criminal conduct against the company (such as embezzlement)**

☐ **Option 1b: A serious breach of the owner's duties or of any written policy of the company**

☐ **Option 1c:** _____

(c) If an owner is expelled for a reason listed in subsection (b), the price that the company or the continuing owners will pay for the expelled owner's ownership interest will be:

☐ **Option 1d: The full Agreement Price according to the "Agreement Price" section of this agreement**

☐ **Option 1e: Decided by an independent appraisal, according to the Appraised Value Method in the "Agreement Price" section of this agreement**

☐ **Option 1f: The Agreement Price as established in the "Agreement Price" section of this agreement, decreased by _____%**

Section 4: Agreement Price

Unless otherwise provided in this agreement, the undersigned agree that the method checked below for valuing the company shall be used to determine a price for ownership interests under this agreement.

[*You must check one and only one of the valuation methods below.*]

☐ **Valuation Method 1: Agreed Value**

The agreed value of the company shall be $ _____ , or such other amount as fixed by all owners of the company after the date this agreement is adopted as specified in a written statement signed by each owner of the company. If more than one such statement is signed by the owners after this agreement is adopted, the statement with the latest date shall control for purposes of fixing a price for the purchase of ownership interests under this agreement. The value of an individual owner's interest shall be the entire value for the company as determined under this paragraph, multiplied by his or her ownership percentage.

☐ **Valuation Method 2: Book Value**

The value of the company shall be its book value (its assets minus its liabilities as shown on the balance sheet of the company) as of the end of the most recent fiscal year prior to the purchase of an ownership interest under this agreement. The value of an individual owner's interest shall be the entire value for the company as determined under this paragraph, multiplied by his or her ownership percentage.

☐ **Valuation Method 3: Multiple of Book Value**

The value of the company shall be _____ times its book value (its assets minus its liabilities as shown on the balance sheet of the company) as of the end of the most recent fiscal year prior to the purchase of an ownership interest under this agreement. The value of an individual owner's interest shall be the entire value for the company as determined under this paragraph, multiplied by his or her ownership percentage.

☐ **Valuation Method 4: Capitalization of Earnings (Adjusted for Income Taxes)**

The value of the company shall be determined on the basis of _____ times the average net earnings (annual gross revenues of the company minus annual expenses and minus any annual federal, state, and local income taxes payable by the company) for the _____ fiscal years of the company (or the number of fiscal years the company has been in existence, if fewer) that have occurred prior to the purchase of an ownership interest under this agreement. The value of an individual owner's interest shall be the entire value for the company as determined under this paragraph, multiplied by his or her ownership percentage.

☐ **Valuation Method 5: Appraised Value**

The value of the company shall be its fair market value as determined by an independent appraiser mutually selected by the Buyer(s) and Seller of the ownership interest subject to purchase under this agreement. If the Buyer(s) and Seller are unable to agree upon an independent appraiser within 30 days, within the next 10 days, each shall select an independent appraiser. If the selected appraisers are unable, within 60 days, to agree on the fair market value of the company, then the appraisers shall select an additional independent appraiser within the next 10 days, who shall, within 30 days, determine the fair market value of the company. The Buyer(s) and Seller shall equally share all costs of an appraiser mutually selected by the Buyer(s) and Seller or of an additional appraiser. All costs of an individually selected appraiser shall be paid by the party selecting the appraiser. The value of an individual owner's interest shall be the entire value for the company as determined under this paragraph, multiplied by his or her ownership percentage.

Section 5: Payment Terms

Unless otherwise provided in this agreement, the undersigned agree that the payment terms checked below shall be used for the purchase of ownership interests.

[*You must check one and only one of the payment terms alternatives below.*]

☐ **Payment Terms Alternative 1: Full Cash Payment**

Cash payment for the Seller's ownership interest shall be made by the Buyer(s) to the Seller within _____ days of the date the company provides a Notice of Intent to Purchase to the Seller under this agreement.

☐ **Payment Terms Alternative 2: Monthly Installments of Principal and Interest**

The Buyer(s) shall pay the Seller the purchase price for an ownership interest in equal installments over a term of _____ months, with interest added to the amount of each installment computed at an annual rate of _____ and compounded annually on the unpaid continuing balance of the purchase price of the ownership interest. The buyer shall make the first installment payment to the Seller by _____, and the continuing payments shall be made on the _____ of every month, until the full purchase price, together with any interest owed, is paid in full.

☐ **Payment Terms Alternative 3: Customized Schedule for Payment for Ownership Interest**

The Buyer(s) shall pay the Seller the purchase price for the ownership interest according to the schedule and other terms included below:

_____

_____

_____

Section 6: Signatures

_____

Moving on to the real meat of the buy-sell agreement, you'll find samples of the three most important clauses:

- a limitation on the transfer of ownership interests, or right of first refusal
- a right to force buyouts, and
- a method to determine share price.

You'll also find a fourth provision:

- payment terms, which outline a few alternatives for how a buyout will be paid.

These sample provisions stick to the basics and are a skeletal version of a full buy-sell agreement. Consider having an attorney or business consultant review yours once you've drafted it. They might point out potential additional issues that are not covered in this chapter, such as tax and estate planning considerations.

All business owners would be wise to take these issues seriously from the get-go; it's especially important for businesses that have accumulated significant assets, and for business owners who are concerned about estate planning.

Chapter 15 Checklist: Planning for Changes in Ownership

- ☐ If your business will have more than one owner, consider the various situations that can raise ownership questions: retirement, illness, disability, death, divorce, or conflict among business owners.
- ☐ To control the transfer of ownership shares in your business, include buy-sell provisions in your business formation document such as your partnership agreement or LLC operating agreement; or in a separate agreement. (The sample clauses in this chapter are for use in your existing business formation document.)
- ☐ To limit the ability of a business owner to sell a business interest to an outsider, use a right-of-first-refusal clause.
- ☐ To force an owner or someone who has acquired an interest in the business to sell the interest to the current owners, use an option-to-purchase clause.
- ☐ To force the other owners of the business to purchase a departing owner's share, include a forced buyout clause.
- ☐ Remember to include provisions for how the price will be set for ownership shares being sold, and payment terms.

CHAPTER

16

Building Your Business and Hiring Workers

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If all your careful planning, hard work, and good karma pay off, you might find yourself needing to expand your thriving business by hiring help. Or, perhaps your business plan includes staff from day one. This chapter offers an overview of the many laws that apply to businesses that have one or more employees. If you're thinking about hiring an employee but aren't sure about how or whether to do it, the information here should help you understand what you're getting into—and help you figure out whether there's a better way to go.

In addition to considering the practical and financial concerns involved in hiring people to work for you, you should understand the legal difference between employees and independent contractors. This distinction is crucial, because different rules apply depending on what kind of workers you have. If the government considers your workers to be employees, you'll have to follow a number of state and federal laws and pay employment-related taxes. If, on the other hand, your workers can be characterized as independent contractors, you'll be spared many—but not all—of these financial and legal requirements.

Employees Versus Independent Contractors

Anyone who works for your business (other than a business owner) is either an employee or an independent contractor (IC). In a nutshell, an employee is someone who works for you, on your site, with your tools and equipment, and according to your rules and procedures. Independent contractors, on the other hand, are in business for themselves; they work on their own time and with their own tools, and perform services for a number of different clients.

This is not a distinction to be taken lightly. Businesspeople who hire employees owe a number of employment taxes, such as payroll tax and unemployment tax, while those who hire only independent contractors do not owe these taxes. If you treat an employee as an independent contractor and fail to pay employment taxes, you risk subjecting yourself to a huge back-tax bill, plus interest and other state and federal penalties. More than a few businesses have been torpedoed and sunk into bankruptcy after making this costly mistake.

With that warning in mind, here's the lowdown on classifying your workers.

The Agencies That Matter

Wages paid to workers classified as employees are subject to payroll taxes, so it shouldn't surprise you to learn that the IRS takes a great interest in whether your workers are classified properly. State rules for classifying workers may be stricter than or otherwise different from the IRS rules, but the state penalties can be at least as harsh as those imposed by the IRS. The state agency that enforces worker status rules is generally called an employment agency, tax department, unemployment office, or other employment-related bureau.

IRS Criteria

The IRS's Publication 15-A, *Employer's Supplemental Tax Guide*, will help you determine whether a worker is in fact an independent contractor or an employee. It is available online at www.irs.gov.

A worker should normally be considered an employee, not an independent contractor, when he or she:

- works only for you and not for any other business
- works on your premises
- uses your tools and equipment
- follows work hours you set
- follows your instructions on how to complete a job
- receives reimbursement for expenses incurred in doing a job
- supervises any of your other workers, or
- receives any employee benefits, such as holiday pay, vacation time, or health insurance.

On the flip side, workers are independent contractors when they:

- work for a number of different businesses or clients
- have a personal office, studio, garage, or other permanent place to work
- own equipment and tools used for the work
- set their own hours
- use independent judgment as to how to complete a job
- don't get reimbursed for expenses incurred in doing a job, and
- advertise services to the public.

Of course, a worker might display some characteristics of each category, which makes it harder to say for sure how the government (and you) should classify that worker. Ultimately, you'll need to consider these factors all together and weigh them against each other to decide whether a worker is an employee or an independent contractor.

EXAMPLE 1: Bob does a lot of freelance proofreading for a publisher of books on alternative health, Wholeness Press. He often works for Wholeness Press (about ten projects per year), but he also does four or five jobs per year for other publishers. He always works at home, receives minimal instructions as to how to do his work, and does his proofreading whenever he feels like it, though he always meets his deadlines. Bob can probably be categorized as an independent contractor.

EXAMPLE 2: Susan programs almost exclusively for one software developer, Fizz Games, but she also does approximately one outside project per year. She sometimes works from home but often uses a computer at Fizz Games' office. She works closely with the software development team at Fizz Games, following instructions from some of the developers while training some of the newer workers in programming techniques. The government is likely to see Susan as an employee. It would be risky for Fizz Games to treat her as an independent contractor.

In borderline situations, it's safer to treat a worker as an employee than risk the penalties that may result if the IRS or your state decides you've misclassified an someone as an independent contractor. The IRS and most state authorities tend to disfavor independent contractor status. They'd much rather see borderline workers classified as employees so that they can collect taxes on them.

If you can't decide how one of your workers should be classified, you can always consult a lawyer or an accountant who understands business tax laws. Or, go straight to the horse's mouth and ask the IRS or your state agency to tell you how they would classify a certain worker.

You can file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, to request a formal ruling from the IRS on a worker's status. Don't be surprised if the IRS classifies your worker as an employee.

For a state determination, contact your state employment or other agency that governs worker classification. Like the IRS, states commonly classify workers as employees rather than independent contractors. You'll have to decide for yourself whether to leave the determination up to these agencies, or to classify your workers on your own.



SKIP AHEAD

For businesses with ICs only.

If you decide that all of your workers will be independent contractors (and you're sure that you've classified them correctly), the rest of the rules in this chapter won't apply to you. You might still want to read on, however, if you'd like to get an overview of the regulations that apply to businesses with employees.



CAUTION

Hiring ICs triggers some requirements. For instance, if you pay any independent contractor over $600 in a year, you need to report those payments on IRS Form 1099-MISC, *Miscellaneous Information*, then send it to the worker and to the IRS. For in-depth information about hiring independent contractors, see *Consultant and Independent Contractor Agreements*, by Stephen Fishman (Nolo).

Special Hurdles for Employers

As soon as you hire your first employee, you unleash a swarm of legal requirements that apply specifically to employers. Not only will you have to pay a number of employment taxes, but you'll also need to register with certain government agencies, pay for certain types of insurance, and comply with various laws, such as those requiring you to keep a smoke-free workplace and to post certain notices at your business premises.

Though the many laws that apply to employers are beyond the scope of this book, here's an overview of the major requirements that apply to businesses with employees. If you hire employees, you'll need to consult additional resources to make sure you comply with the many state and federal laws governing employers. (Some additional resources are included below.)

In general, owners of businesses with one or more employees are required to take a number of steps:

- Report all new hires to your state's employment department within 20 days of the employee's first day of work.
- Obtain workers' compensation insurance, and follow the rules on notifying employees of their rights to workers' compensation benefits. You may purchase this insurance from a state fund or, in most states, from a private insurance company.
- Comply with state and federal job safety laws, administered by the federal Occupational Safety and Health Administration (OSHA) and the agency in your state that governs workplace safety. Requirements include filing an illness and injury prevention plan, reporting work-related injuries and illnesses that result in lost work time, and keeping a log of all work-related injuries and illnesses. For more information about OSHA regulations, visit the OSHA website at www.osha.gov.
- Withhold federal income taxes and FICA taxes (which basically consist of Social Security and Medicare taxes) from employees' paychecks, and periodically report and send these withheld taxes to the IRS. See IRS Publication 15, Circular E, *Employer's Tax Guide*, for details.

- Report wages and withholding to each employee and to the IRS with Form W-2.
- Pay the employer's portion of Social Security and Medicare tax for each employee, based on the employee's wages. The employer's portion is the same amount as the employee's share: 7.65% of the employee's wages up to $142,800, and 1.45% of wages in excess of that amount, according to rates for the year 2021.
- Withhold state income taxes from employees' paychecks, and periodically deposit them with your state income tax agency.
- Pay federal unemployment taxes. It's the sole responsibility of the employer to pay the federal unemployment tax (FUTA) directly to the IRS; you may not deduct it from employees' paychecks. The general rule is that you must pay FUTA taxes if you paid a total of $1,500 or more in wages in any calendar quarter, or if you had one or more employees for at least some part of a day in each of 20 or more calendar weeks (not necessarily consecutive) during the year. The FUTA tax is reported annually on IRS Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*.
- Pay state unemployment taxes, in many states. Most states require employers to pay unemployment taxes, which go toward a state unemployment insurance fund. Generally, you can take a credit against the federal unemployment tax for amounts you paid on time into state unemployment funds. A list of state unemployment tax agencies is available in IRS Publication 926, *Household Employer's Tax Guide*.
- Pay or withhold other employment-related taxes that might be required by your state, such as disability insurance.
- Confirm employee eligibility to work in the United States, by completing U.S. Citizenship and Immigration Services (USCIS) Form I-9.



CAUTION

Make payroll taxes a top-priority expense. The owner of a cash-strapped small business might be tempted to put off paying payroll taxes for a quarter, or a year. "This happens all the time, but it is a huge mistake. It can lead to jail time," says David Rothenberg, a CPA. You must include payroll taxes in your cash flow planning and pay those taxes regularly.

Thinking twice about becoming an employer? There's no way around it: Adding employees to your business adds to your obligations and responsibilities, both financial and paperwork-related. (If you decide to provide benefits such as health insurance and 401(k) plans, you've added more work.) Many businesses get their feet wet by hiring independent contractors first, then hiring these workers as regular employees. This is a fine strategy, as long as you don't make the mistake of abusing the independent contractor classification.



RESOURCE

For more information on being an employer. As noted above, you'll need to check several government agencies (including the IRS, OSHA, USCIS, and your state employment department and income tax agency) to comply with legal requirements that apply to employers. If you want all the information in one place, see *The Employer's Legal Handbook*, by Fred S. Steingold (Nolo), an indispensable, comprehensive reference for employers that covers the legal rules on hiring, firing, taxes, workplace safety, and much more. And for lots of free articles, see the "Employment Law" section of Nolo.com.

Hiring and Managing Staff

This section outlines a simple, systematic approach to recruiting people to work for your business. This approach focuses on creating clearly defined positions, organizing them into an efficient structure, and managing the workers who perform them.

Determine What Tasks Need to Be Done

The first step in hiring staff is to clearly define what needs to be done. Do you need help answering phones? Managing a retail store? Making donuts? The clearer you are about what needs to be done, the easier it will be for workers to meet these expectations.

Defining tasks can be somewhat overwhelming for business owners in the start-up stage. When considering what you need help with, your initial reaction will probably be, "Everything!" The best way to clear this hurdle is to evaluate your business plan and develop solid systems for all aspects of your business. For example, you'll want a well-established system or procedure for how the business will provide its products or services, how it will track inventory, what records it will keep and how it will keep them, how it will track employees' time, and so on. When you have sketched out a system for each of the essential tasks, it will be much easier to see what tasks need to be handled by someone other than you, a business partner, or an existing independent contractor.

Create Positions and Job Descriptions

With a solid and realistic task list in hand, the next step is to group tasks together for each position. Certain activities will fall together naturally. For instance, the tasks of answering phones, updating databases, managing office supplies, and doing very basic bookkeeping might combine well into one position. Ordering inventory and managing retail sales might similarly fall into a distinct task set.

Once tasks are grouped together, you can create job positions to handle those areas. The office tasks mentioned above, for instance, could go to an office manager. Tasks such as ordering inventory and managing sales might well be headed by a sales manager.

It's important to write out a formal job description for each permanent position. Creating job descriptions not only will help in the hiring process, but will be valuable when it's time to review an employee's performance. Fortunately, writing job descriptions should be easy if you have created the position from a task-based to-do list; the job description can simply restate the list in slightly more polished form.

Implement Diversity, Equity, and Inclusion Policies

Every business—especially those that hope to grow—should take time to think about how to maximize staff diversity, so as to include people with a range of perspectives and backgrounds. The field of Diversity, Equity, and Inclusion, or DEI encompasses practices to help accomplish this. It's based in part on an increasing recognition that too many industries concentrate power within small, homogenous groupings, which tend to be white, male, and privileged in terms of financial and educational backgrounds. DEI practices try to examine the systemic reasons for this, dismantle them, and create new systems that distribute power (and in turn, wealth) more democratically.

At a practical level, for many small businesses, DEI work starts with working actively and regularly on defining company values, and implementing systems to keep the company's work aligned with those values. The company considers what diversity, equity, and inclusion mean—ideally, in an ongoing inquiry. The goal is usually to be inclusive of all races, genders, physical abilities, sexual orientations, socioeconomic backgrounds, and other

categories of socially marginalized or underrepresented people, and for power to be distributed equitably among the diverse crew.

The next step is to create processes and systems to maximize DEI in the workplace. Some examples of DEI practices include:

- Holding workshops to discuss company values, develop working definitions of these values, and draft statements to share publicly. Not all companies put out public values statements, but doing so can help keep the values in focus.
- Developing guidelines for incorporating DEI considerations into various aspects of the business, including hiring and beyond. Internal and public-facing communications, for example, can unwittingly promote exclusion or gate-keeping.
- Creating practices to "catch, own, and repair" situations where someone was harmed by bias or microaggressions, whether intentionally or subconsciously.
- Learning about nonviolent communication in order to provide staff with the tools to engage with each other transparently and address problems constructively.

When engaging in DEI work, you should aim to make the process transparent, encourage participation, and document your steps along the way. How you communicate information to your staff and open your process to their participation is important. Actively working to promote an equitable culture within your business is one of the most powerful ways to go beyond merely making "inclusivity statements," which become empty when not acted upon.

Being thoughtful about values and systems isn't just for big corporations. Tiny firms can greatly strengthen their teams by thinking about and implementing systems to bring diversity, equity, and inclusion into their culture. As you develop your management philosophy and policies, remember that you have the power to create a model that puts your values into practice.

Develop Staff Hierarchies

Progressive-minded folks sometimes look at staff hierarchies as undemocratic or somehow oppressive. Without getting into a treatise on the virtues or evils of various types of power structures, suffice it to say that a little structure goes a long way toward ensuring the efficient operation

of any organization. That's not to say that it's necessary to create a multilayered, command-and-control reporting system. If your business will have five or more regular employees, however, it's important to take the time to designate clear lines of authority and accountability. In small businesses, this often means that everyone reports to one of the business owners. As the business grows, you'll probably want to add a second layer of managerial accountability—for example, to require marketing associates to report to the sales and marketing manager, not directly to the business owner.

Create Review Procedures

Every business should implement an evaluation procedure before hiring anyone. That way, new employees know what to expect from the very first day. The review procedure needn't be complex; it might simply identify who will participate in reviews, when they will occur, and the criteria by which staff will be measured.

Create an Employee Handbook

A handbook for employees serves a vital role, giving everyone ready access to important information about their jobs. Even more important, creating an employee handbook is a powerful way to minimize the risks posed by anyone who works for your business. As discussed in more detail in Chapter 8, a business's potential risk of a liability or contract lawsuit goes way up as soon as it hires even one employee. Not only can workers potentially harm someone and expose the business to a lawsuit, they could sue the business for a host of discrimination, wrongful termination, or other claims.

To create a handbook, the business owner or high-level manager will have to spend some time coming up with a set of rules for employees to follow and procedures the business will use in dealing with workers. Facing and answering these questions will help ensure that your employment practices are sound. And compiling these policies in a guidebook promotes positive staff relations by demonstrating your business's commitment to fair treatment for all workers, according to the same set of rules.

Employee handbooks typically include information on:

- hiring
- hours and flextime
- sick and vacation leave
- parental leave
- employee benefits
- performance review procedures
- workplace behavior
- health and safety
- employee privacy

- conflicts of interest
- discrimination and harassment
- grievance procedures, and
- termination.

Lots of new business owners find the prospect of creating a staff handbook too overwhelming in their harried early days. While this is understandable, it's a good idea to tackle the task earlier rather than later—it will be easier to create a handbook before the staff grows large and complex. It's simply unwise to have more than a few employees without a written policy manual.



RESOURCE

Resource for creating your employee handbook. All businesses with employees would be wise to take this task seriously. An excellent guide is Nolo's *Create Your Own Employee Handbook,* by Sachi Clements. This book walks you step-by-step through creating an employee handbook, explaining the issues and offering sample language you can modify to fit your workplace.

Orient New Employees

When employees come on board, it's important to take some time to introduce them to your world. For efficiency's sake, create a standard orientation process—it could be a short meeting and video shown in a conference room, a walk-through of the office, or a get-together at your house—to explain the ins and outs of working for the business. If and when you have several employees coming on board at once, you can save time by orienting them as a group.

All new hires should receive basic information about the business, but you'll want to provide a more extensive orientation for higher-level positions. For example, you might want to spend a significant amount of time with a general manager—say, a series of meetings over a few days—to make sure the manager really understands what the business is about and how you want it to be run. This might include discussing the business's history and any past problems that you do not want to see repeated. For regular employees, on the other hand, this much information would be overkill.

A good starting point is to provide each new employee with a copy of your employee handbook. If you're starting out with just a handful of employees, perhaps a couple hours of orientation followed by lunch might work. As your staff grows, you might want to have new hires attend presentations by a manager or supervisor. Pairing new employees with experienced ones for a mentorship period is also a good way to bring newcomers on board.

Chapter 16 Checklist: Building Your Business and Hiring Workers

- ☐ Become familiar with the legal differences between employees and independent contractors.
- ☐ Before hiring help, determine whether you need to hire employees or whether you could use independent contractors instead.
- ☐ Don't try to avoid the obligations of having employees by misclassifying your workers as independent contractors. If the IRS decides your workers are really employees, you can face serious penalties, including payment of back payroll taxes.
- ☐ Make sure you're ready to take care of all the legal, bureaucratic, and tax requirements that apply to businesses with employees before hiring your first one.

CHAPTER

17

Getting Legal and Other Professional Help

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In this book, we have tried to give you the information and refer you to the tools you need to handle a range of business and legal tasks involved in starting and running your own business. But you might prefer to work with an accountant or attorney on certain tasks.

Or you might need expert advice in special situations. Maybe you're struggling to decide whether it's a good time, financially speaking, to expand your business. Perhaps a dispute is brewing between you and a business partner. You might be entering into a complicated business deal and you need a specialized contract for it. An expert can come in handy in such situations.

Of course, using an accountant or attorney needn't be a last resort. We recommended previously that you should us an accountant or tax service to prepare your business tax returns. You might recognize other startup or ongoing tasks that would be best farmed out. Your comfort level with a given task and your budget for professional services will determine whether you handle the task on your own or hand it off to your accountant or attorney.

If you do find yourself engaging an accountant or attorney, what you've learned from this book will make you a more informed client. The more informed you are about a given business issue, the more effectively and efficiently you'll be able to work with your team of professionals. This chapter provides additional information on dealing with attorneys, accountants, and other professionals.

Working With Lawyers

As with all professions, there are great attorneys and not-so-great attorneys. You obviously want one of the better ones. But no matter how knowledgeable and skilled an attorney is, they might not be the right attorney for you. This section will help you evaluate the fit between you, your business, and a prospective attorney.

What to Look for in a Lawyer

You'll want an attorney who has some experience with small business issues, preferably for your type of business. Any competent small business attorney can handle basic startup tasks and generic contracts. But if you have specialized legal needs, perhaps due to a complicated ownership situation or the need for industry-specific contracts, it's usually a good idea to find an attorney with such specialized experience.

In addition to finding a lawyer with the skills and experience relevant to your situation, it's important that you and the lawyer get along on a personal level. This general rule is especially true for small business owners, who will ideally develop a long-term relationship with a lawyer. The better an attorney knows you and your business, the better equipped they will be to provide the best advice and assistance for your situation.

How to Find a Lawyer

The best way to find a good lawyer is to get a personal referral, such as from your accountant, banker, or someone who runs a small business similar to yours. Book publishers, for instance, face different types of legal issues than do auto repair shops, and would be best served by a lawyer familiar with legal areas such as copyright and free speech.



RESOURCE

Looking for a lawyer? Nolo offers some excellent resources to help in your search.

- **Nolo's Lawyer Directory.** Nolo has an easy-to-use online directory of lawyers, organized by location and area of expertise. You can find the directory and its comprehensive profiles at www.nolo.com/lawyers.
- **Lawyers.com.** At Lawyers.com, you'll find a user-friendly search tool that allows you to tailor results by area of law and geography. You can also search for attorneys by name. Attorney profiles prominently display contact information, list topics of expertise, and show ratings—by both clients and other legal professionals.
- **Martindale.com.** Martindale.com offers an advanced search option that allows you to sort not only by practice area and location, but also by criteria like law school. Whether you look for lawyers by name or expertise, you'll find listings with detailed background information, peer and client ratings, and even profile visibility.



TIP

First impressions are important. You might get a good idea of how an attorney operates by paying close attention to the way your call is handled. Is the lawyer available right away, and, if not, is your call promptly returned? Is the lawyer willing to spend at least a few minutes talking with you to determine whether the two of you are a good fit? Do you get a good feeling from your conversation? How you're treated during your initial call can be a good indicator of how the lawyer treats clients in general. (This advice applies to inquiries that you make by email or by filling out a form on the lawyer's website.)

Legal Fees

Before you hire a lawyer, be sure you fully understand how your fees will be calculated. Lawyers generally use one of the following methods of billing for their services:

- **Hourly fees. T**his arrangement works just like it sounds: You pay the attorney's hourly rate for the number of hours the attorney spends on your case. Simple as this system is, it has some details to consider. First, learn what hourly increments the lawyer uses for billing. Most bill in 10- or 15-minute increments. Be careful about longer billing increments. For instance, if an attorney bills in half-hour increments, you'll be charged for a full half-hour even if you talk for just five minutes. You'd be better off if your lawyer bills in 10- or 15-minute chunks.

Another issue to ask about the rates for work by others in the attorney's office, such as paralegals or administrative staff. If you are billed for any non-attorney work, it should be at a lower rate than the attorney's hourly fee. The hourly fee for the attorney should apply only to the work of the actual attorney.

Hourly fees for small business attorneys can range from $200 to over $400 per hour. High rates might reflect a lawyer's extensive experience—or they might simply reflect a need to pay for a swank office. The lawyer's location can make a big difference too; a lawyer in New York City might charge four times what a lawyer in Taos charges. You should expect the lawyer's rate to be comparable to attorneys in your area doing similar work, perhaps moderated a bit up or down based on the attorney's experience and expertise.

- **Flat fees.** For some types of work, attorneys will charge a flat fee for a specific task, such as filing articles of incorporation or registering a trademark. As long as the job goes as expected, you'll pay only the agreed price, regardless of how many hours the lawyer spent on the job. Make sure the lawyer is clear on what is and is not included in the flat fee. For example, does the flat fee for incorporation include drafting your bylaws? Also, be clear on the circumstances, if any, under which the attorney can increase the fee. For example, with a trademark registration, the flat fee might cover the initial application and a response to one Office Action (preliminary denial or request for clarification) from the Trademark Office. Responses to additional Trademark Office actions would be billed above and beyond the flat fee.
- **Contingency fees.** In a contingency fee arrangement, you pay an attorney's fee only if the lawyer wins money for you through a court judgment or a negotiated settlement. In that case, the fee you'd pay would be a percentage of the monetary award, usually one-third to one-half. In contingency fee arrangements, you need to be especially careful of costs such as travel expenses, transcription fees, and phone bills. If you lose your case, you won't owe attorneys' fees (because your lawyer didn't recover any money). But you will often be responsible for the lawyer's out-of-pocket expenses incurred while working on your case.

Small business matters don't typically require contingency fee arrangements. This payment method

is usually used in personal injury cases and others in which a plaintiff sues someone in hopes of winning a large money award.

- **Retainers.** Sometimes you can hire a lawyer to be more or less "on call" by paying a regular fee (usually monthly) called a retainer. This type of arrangement is useful when you have regular, ongoing legal needs such as contract review or negotiation. Based on your expected needs, you and the lawyer settle on a monthly fee. Then you simply have the lawyer take care of any routine legal matters that arise. If you run into a sudden, complex legal dispute, or if your problems escalate greatly, you'll likely have to make additional payments. For this type of arrangement to work, it's important that you and the lawyer have a clear understanding of the routine services that you expect. Unless your legal needs are regular and predictable, a retainer arrangement is probably not your best option.

State laws often require that a fee agreement be in writing in some cases, such as when your lawyer estimates the total cost of legal services to be more than $1,000, or when you have a contingency fee arrangement. Even if it's not legally required, it's always a good idea to get your fee agreement in writing. A written agreement will help prevent disputes over billing.

Expenses

Under all types of billing arrangements, be clear on whether you will be charged for law firm expenses incurred on your behalf, such as copying and mailing costs.

Working With Accountants and Other Financial Professionals

Your accountant is another member of your professional team. Many of the issues that small business owners face can be solved by professionals other than lawyers. Tax professionals, in particular, can help you not just with tax preparation, but also with tax planning and saving. A good tax adviser can help you stay compliant with the IRS while minimizing your tax bill. In fact, tax advice is so essential to a successful small business that we recommend that every small business owner should consult with a tax expert at least once a year.

Matching People to Your Needs

For routine maintenance of your books, you probably don't need the experience—or expense—of an accountant (certified or otherwise). An experienced bookkeeper will be able to put in place an effective system of tracking your income and expenses and staying on top of your important bills, including the various taxes your business will owe. Depending on the complexity of your business, you might even decide to do your own bookkeeping. As your business grows, however, an experienced bookkeeper will likely become a valuable investment.

If you find yourself seeking tax advice or encountering tricky financial problems, you might need to go up a step on the professional ladder and hire an accountant. The top dogs of accountants are called certified public accountants (CPAs), who are licensed and regulated by the state.

In addition to accountants, other professionals specialize in tax preparation. Some are licensed and some are not. An enrolled agent (EA) is a tax professional, licensed by the IRS, who can answer tax questions and help you prepare your returns. Others who simply use the title "tax preparer" or "tax return preparer" might not be licensed at all. However, per the IRS, anyone paid to prepare tax returns for others ("paid tax preparers") is expected to have the necessary tax expertise and must have an IRS-issued preparer tax identification number (PTIN). If a tax professional doesn't have a license as an enrolled agent or as a public or certified public accountant, it could mean that the "professional" has no official qualifications whatsoever.

The bottom line is that you should hire the person who is best equipped to meet your needs—don't pay a CPA to do simple bookkeeping, or use a bookkeeper for preparing complex tax returns.

Finding Good Professional Tax Help

Finding a tax professional is a lot like finding a lawyer: Your goal is to find someone both competent and trustworthy. The strategies discussed above for finding a lawyer (personal referrals or from other businesspeople) are equally useful in finding other professionals. Because virtually every business has consulted a tax pro at one point or another, it shouldn't be too hard to get a decent list of names.

As with attorneys, choose a tax professional carefully, with an eye to developing a long-term relationship. Don't be shy about asking questions. Find out about the person's experience with small businesses similar to yours, and ask about their qualifications generally.

Be sure you understand the professional's fee structure up front, before any work is done. Most charge a flat fee per return and an hourly fee for other work, such as responding to IRS inquiries on your behalf. Like your attorneys' fee agreement, your fee agreement with a tax professional should be in writing. It should clearly state the work to be done, deadlines for completion and what information you, as the taxpayer, are responsible for providing to the tax pro.

You Are Responsible for Your Tax Return

In the eyes of the IRS, you, the taxpayer, are responsible for the completeness and accuracy of your returns. Even if you paid a professional to prepare a return, you, not the preparer, are responsible for any deficiencies in the return.

Your tax preparer is responsible to you for any errors they make in the preparation of a return, but a preparer's error does not let you off the hook with the IRS, including for any interest and penalties they might assess.

Also, most preparer fee agreements (also known as engagement letters) state clearly that you, the client, are responsible for the substance (the numbers) in your return. If the numbers you provide to the preparer are off, that's on you, not them. They prepare your returns with the information you give them.

Doing Your Own Research

If you don't want to call your lawyer or accountant every time you have a legal or tax question, you might consider doing a little online research yourself.

Start by visiting Nolo's website at www.nolo.com and checking under the "Legal Articles" menu item to get background information in the area of the law that interests you.

Here are some other websites that offer helpful information on small business and tax law:

- National Federation of Independent Business at www.nfib.com. Here you can find small business news and practical information.
- Internal Revenue Service at www.irs.gov. You can download forms and instructions as well as a wide range of publications that do a fairly good job of explaining the tax laws.
- U.S. Small Business Administration at www.sba.gov. This site has a lot of good information on starting and financing your own business. The SBA also offers links to state websites related to business issues.
- SCORE (Service Corps of Retired Executives) at www.score.org. SCORE's association of retired executives and business owners offers email counseling and mentoring and an excellent directory of small business resources on the web.

- At www.congress.gov, you can read small business bills pending in Congress, as well as laws that have recently been adopted.



RESOURCE

State Website. Your state's secretary of state, revenue department, and other state departments and agencies maintain websites with valuable information for small businesses, including start-up registration requirements, state tax rules, laws on corporations and LLCs, and much more.

Chapter 17 Checklist: Getting Legal and Other Professional Help

- ☐ Ask business associates and friends for recommendations for lawyers, as well as accountants or other tax professionals. Also check out online lawyer directories and referral sites for lawyers in your area.
- ☐ Decide which legal and accounting tasks you want to handle yourself and which you want to hand off to your attorney or accountant.
- ☐ Get your fee agreements in writing.
- ☐ Become familiar with online sources of legal information such as www.nolo.com, the IRS website, and your official state websites.

APPENDIX

A

How to Use the Downloadable Forms on the Nolo Website

Editing RTFs 414

List of Forms Available on the Nolo Website 415

This book comes with downloadable files that you can access online at: **www.nolo.com/back-of-book/SMBU.html**

To use the files, your computer must have specific software programs installed. Here is a list of types of files provided by this book, as well as the software programs you'll need to access them:

- **RTF.** You can open, edit, print, and save these form files with most word processing programs such as Microsoft *Word*, Windows *WordPad*, and recent versions of *WordPerfect*. On a Mac, you can use Apple Pages. You can also work with the forms through a word processing app such as Google Docs (www.docs.google.com).
- **PDF.** You can view these files with Adobe *Reader*, free software available from www.adobe.com. The government PDFs provided by this book can be filled using your computer, or they can be printed out and completed by hand.
- **XLS.** You can open, edit, print, and save these spreadsheet files with Microsoft *Excel* or other spreadsheet programs that read XLS files.

Editing RTFs

Here are some general instructions about editing RTF forms in your word processing program. Refer to the book's instructions for help about what should go in each blank.

- **Underlines.** Underlines indicate where to enter information. After filling in the needed text, delete the underline.
- **Bracketed and italicized text.** Bracketed and italicized text indicates instructions. Be sure to remove all instructional text before you finalize your document.
- **Optional text.** Optional text gives you the choice to include or exclude text. Delete any optional text you don't want to use. Renumber numbered items, if necessary.
- **Alternative text.** Alternative text gives you the choice between two or more text options. Delete those options you don't want to use. Renumber numbered items, if necessary.
- **Signature lines.** Signature lines should appear on a page with at least some text from the document itself.

Every word processing program uses different commands to open, format, save, and print documents, so refer to your software's help documents for help using your program. Nolo cannot provide technical support for questions about how to use your computer or your software.



CAUTION

In accordance with U.S. copyright laws, the forms provided by this book are for your personal use only.

List of Forms Available on the Nolo Website

To download the following forms, go to:
www.nolo.com/back-of-book/SMBU.html

Forms in RTF format:

Form Title	File Name
Partnership Agreement	Partnership.rtf
Sample Buy-Sell Agreement Provisions	BuySellSample.rtf

Forms in Adobe *Acrobat* PDF format:

Form Title	File Name
Supplement: Working With a Web Developer to Create a Custom Site	CustomSite.pdf
IRS Instructions for Form SS-4	iss4.pdf
IRS Form SS-4	fss4.pdf
IRS Form 8716	f8716.pdf
IRS Form 8832	f8832.pdf

Forms in spreadsheet XLS format:

Form Title	File Name
Cash Flow Projection Worksheet	CashFlow.xls
Profit/Loss Forecast Worksheet	ProfitLoss.xls
Break-Even Analysis Worksheet	BreakEven.xls
Billable Rate Worksheet	BillableRate.xls
Warranty Track Worksheet	Warranty.xls
Balance Sheet	BalanceSheet.xls

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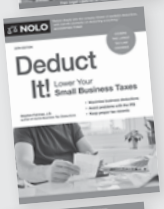
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